

STATE OF ILLINOIS
ILLINOIS COMMERCE COMMISSION

Illinois American Water Company)	
Proposed Increase in Water and)	
Sewer Rates)	Docket No. 11-0767
)	

INITIAL BRIEF OF
THE PEOPLE OF THE STATE OF ILLINOIS

REDACTED VERSION

Information Designated as Confidential by IAWC has been redacted
as indicated by “**CONFIDENTIAL ... END CONFIDENTIAL**”

The People of the State of Illinois

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I. INTRODUCTION

The People of the State of Illinois, by LISA MADIGAN, Attorney General of the State of Illinois (“the People” or “AG”), pursuant to the Illinois Administrative Code Part 200.800, 83 Ill. Admin. Code 200.800, submit this Initial Brief in response to Illinois American Water Company’s (IAWC) third rate increase request in six years.¹ This time it requests a \$34.2 million, or 16.15% overall increase in revenues from its water and sewer customers in Illinois. IAWC Ex. 5.01 SR, Total Company. The revenue increases per district vary, with Pekin and Lincoln customers seeing 24.01% and 32.03% increases respectively, are as follows:

District	Revenue Increase Dollars	Revenue Increase Percentage
Zone 1	\$26,025,490	16.67%
Chicago Metro (excluding purchased water)	\$ 3,755,381	11.59%
Chicago Wastewater Chicago Treatment	\$1,562,249	12.38%
Pekin	\$1,738,534	24.01%
Lincoln	\$1,162,858	32.03%

IAWC Ex. 5.01 SR. The effect of the Company’s proposal on residential bills also varies.

Assuming 6,000 gallons monthly usage (which IAWC indicates is the average), residential customers will pay the following increases if the Company’s rate increase requests are allowed:

District	\$ Increase	% Increase
Alton	\$7.931	20.37%
Cairo	\$10.296	23.19%
Interurban	\$8.07	20.65%
Peoria	\$7.93975	19.88%
Streator	\$7.986	21.22%
Pontiac	\$8.83933	19.81%
S. Beloit	\$8.436	28.33%

¹ In Docket 07-0570, IAWC received at \$13,629,267 or 14.90% increase, Order at App. A (July 30, 2008). In Docket 09-0319 it was allowed a \$41,373,528, being a 22.78% increase. Order at App. A (April 13, 2010).

Sterling	\$0.776	1.67%
Champaign	\$7.66467	19.85%
Pekin	\$6.4274	19.85%
Lincoln	\$5.7852	15.34%
Chicago Lake	\$1.2008	3.02%
Chicago Well	\$8.7428	21.61%
Chicago Moreland	\$11.6012	39.53%

Source: IAWC Schedules E-2 and E-5.

In addition to the rate increases requested in this docket, IAWC customers pay a Qualified Infrastructure Plant Surcharge (QIPS) and in the Chicago Metro area most customers pay a purchased water surcharge. In this docket, IAWC asks for another rider – a “revenue adjustment clause” or RAC -- that will surcharge customers in the event that IAWC does not collect the revenues it expects. The Commission should reject this RAC Rider because it would unfairly shift risk and costs from shareholders to ratepayers and shift cost recovery among customer classes and service districts without regard to cost of service principles in order to *guarantee* Company revenues. IAWC has not justified this radical departure from established ratemaking.

Staff and Intervenors, including the People of the State of Illinois, identified numerous deficiencies and inappropriate cost items in IAWC’s requested increase. In summary, the People identified more than \$25 million in adjustments that reduce the Company’s revenue deficiency to no more than \$12 million.² AG Ex. 2.2, Sch. A. In addition to adopting the Staff’s rate of return, the People request that the Commission reduce the Company’s increase request to make the adjustments discussed below. In addition, the People request that the Commission adopt a procedure to capture consolidated tax return savings in situations like that presented in this

² This number incorporates the Staff rate of return of 7.38%. AG Ex. 2.2, Sch. D, referring to Staff Ex. 6.0, Sch. 6.1. The Company’s and the Staff’s capital structure both reflect a historically and unusually small portion of short-term debt. Because short term debt is the lowest cost form of financing, the reduction of the short-term debt component from 3.26% and 2.83% in IAWC’s last two rate cases to only 1.30% unreasonably drives up costs for consumers. AG Ex. 2.0 at 15-16.

docket, where the utility has relinquished significant tax deductions that could reduce rates due to considerations related to the parent company's consolidated tax return. Finally, the People request that the Commission adopt the customer charges developed by AG witness Scott Rubin, and reject IAWC's rate design that will result in total customer charge revenues that exceed customer costs by more than \$10 million.

II. ADJUSTMENTS TO RATE BASE

IAWC claims a rate base of \$717,190,629 which should be reduced to no more than \$680 million, as described more particularly below. See IAWC Ex 5.01 SR, page 1; AG Ex. 2.0 at 8.

A. IAWC's Pension Contributions Are Ordinary Employee Related Expenses And Should Be Removed From Rate Base Because They Are Not Investor Capital Entitled To A Return.

IAWC has included \$10.521 million in its requested rate base representing contributions to its employee pension plan. As both AG witness Smith and Staff witness Hathhorn testified, the Company's contributions to its pension plan are an ordinary cost of operations and are not investments or shareholder supplied funds entitled to a return. AG Ex. 2.0 Rev. at 54-58, Staff Ex. 2.0 at 5.

IAWC argues that its past contributions to its pension should be considered an "asset" because the pension payments were more than IAWC included for that expense in its "base rates." IAWC Ex. 6.00R at 24. This argument must be rejected as inconsistent with basic ratemaking principles. A utility's rates and revenue requirement are based on a test year, with the understanding that they are based on a snapshot of operations. During the period the rates are in effect, actual expenses will certainly vary from the exact levels reported in the rate case, but this deviation is expected with the understanding that the utility's job is to manage its operations with the revenues produced from the rates set in the rate case. Some costs will increase and some will decrease, and the return available to investors will vary as well. This does not mean that

shareholders are entitled to a return on expenses that increased while rates are in effect. Yet, that is precisely the Company's position.

IAWC's contributions to its employee pensions were not above the level required by law, and are appropriately treated as an expense. The Commission has excluded utility pension contributions from rate base and rejected the notion that rates should include a cost of capital for this expense, finding no evidentiary support for the premise that pension contributions are shareholder funds. See, e.g., *Peoples Gas and North Shore Gas*, ICC Docket 09-0166/0167, Order at 35-37 (Jan. 21, 2010). IAWC argues that increased pension expenses become shareholder funds entitled to a rate base return. However, this argument should be rejected by the Commission as contrary to basic ratemaking principles. Indeed, if the utility were allowed to include increased expenses to rate base, the incentive to control costs between rate cases would be lost, and a perverse incentive to increase expenses so that investors could receive a return on an ever-increasing rate base would be created.

In addition, IAWC's contributions to its pension plan do not qualify as a "pension asset." On May 29, 2012, the Commission rejected Commonwealth Edison's argument that it was entitled to a return on a "pension asset" holding that a pension asset (as opposed to a pension contribution) is defined "as the amount by which ComEd's share of the pension plan is overfunded." *Commonwealth Edison*, ICC Docket 11-0721, Order at 113 (May 29, 2012). IAWC's pension has an unfunded liability of \$421 million as of December 31, 2011. AG Ex. 2.0 Rev. at 24. IAWC's pension contributions do not qualify as a pension asset because IAWC is not making a greater pension contribution than it is required to make.

AG witness Smith quantified the adjustment as an \$8.590 million deduction from rate base, representing the Company's improperly claimed pension asset of \$10.521 million, offset by

\$1.931 million in related ADIT, as shown on AG Ex. 2.2, Schedule B-5. This is the same as the Staff adjustment shown on Staff Exhibit 6.01. However, Staff updated the pension adjustment on rebuttal based on updated Company materials in Staff Exhibit 10.01. The People support the updated, net Staff adjustment to remove IAWC's claimed pension asset from rate base.

B. The Commission Should Remove the Costs Associated with IAWC's Service Company's Business Transformation Plan from Rate Base.

IAWC seeks to include in rate base \$27.5 million representing the cost of three new business systems: (1) Enterprise Resource Planning ("ERP"); (2) Enterprise Asset Management ("EAM"); and (3) Customer Information System ("CIS"). IAWC Ex. 9.00 at 2. IAWC assigns \$12,434,000 to the ERP and a combined \$15,027,000 to the EAM and CIS systems. IAWC Ex. 4.00 at 2-6 & IAWC Ex. 4.01. These systems are part of a project that IAWC's parent, American Water Company, calls the "Business Transformation" or "BT" project. IAWC witness Twadelle identified the "core functional areas" of BT as "including human resources, financing and accounting, purchasing and inventory management, capital planning, cash management, and customer and field services." *Id.* at 2. These are the same functions provided for IAWC by the American Water Service Company, and recovered as "Business Support Services." See, e.g., IAWC Ex. 1.00 at 22-23; IAWC Ex. 4.00 at 8; IAWC Ex. 5.01 SR, Line 10; see generally Management Audit of the Fees Assessed to IAWC by its Affiliated Service Company (ICC Docket 10-0366), II-2.

IAWC seeks to include \$19.186 million in BT costs in test year rate base, consisting of \$12.062 million for ERP, \$3.021 million for EAM, and \$4.103 million for CIS. AG Ex. 2.0 Rev. at 21. This amount should be removed from rate base³ because it is inappropriate for IAWC to add American Water Service Company costs to IAWC's rate base because (1) these costs are

³ The adjustment removes \$17.821 million from plant in service, which is net of ADIT. AG Ex. 2.0 Rev. at 28; AG Ex. 2.2 Sch. B-1.

over-allocated to regulated operations, (2) treating BT costs as IAWC rate base violates the terms of the agreement between IAWC and the Service Company, approved by the Commission in ICC Docket 04-0595, and (3) cost over-runs, but none of the expected savings, from this expenditure are reflected in rates, making its inclusion in rate base unfair to consumers.

1. The Commission should not allow IAWC to charge Illinois consumers for Business Transformation charges that are properly allocated to American Water's non-regulated businesses.

The total cost of the BT system to American Water was initially identified as \$286 million, although it has grown to about \$300 million. See Northstar Audit at IV-2. American Water allocated virtually all of these costs – 99.9% -- to its regulated utilities based on customer count. AG Ex. 2.0 Rev. at 22 (actual non-regulated allocated cost designated confidential by IAWC); IAWC Ex. 9.00 at 3. American Water's non-regulated operations account for 12.3% of American Water Works' consolidated revenue in 2011 and are part of the American Water Work's corporate enterprise. AG Ex. 2.0 Rev. at 19. The audit of Service Company costs ordered by the Commission noted that: "AWWSC is organized into two levels: corporate and divisional: The corporate level of the organization performs services that can be universally provided to all companies, or functions that are necessary to support the corporate structure. The divisional level provides services specific to utilities within a region." Northstar Audit at III-5. The Commission should exclude *corporate* and other costs associated with BT properly attributable to American Water's non-regulated businesses from IAWC costs and protect Illinois ratepayers from paying these costs.

The notion that American Water's non-regulated businesses do not use AWWSC services is also belied by the fact that in 2009, 2010 and 2011, the non-regulated businesses were allocated *more* AWWSC Information Technology Department charges than IAWC, and the total percentage of IT charges allocated to regulated utilities was 86.94%. AG Cross Ex. 17. By

contrast, in 2012, 2013 and 2014, in addition to significantly higher IT costs overall, more than 90% of the costs are projected to be allocated to regulated utilities, with IAWC's charges increasing 39%. *Id.*

IAWC has acknowledged in response to data requests that non-regulated affiliates may use BT systems, but their use is optional and will be separately billed on an as-used basis. AG Ex. 2.0 Rev. at 22. In addition to the lack of any apparent reason that functions such as human resources, finance and accounting, purchasing and inventory management, capital planning, cash management and customer services would not be needed by American Water's non-regulated (but still water related) services, the *ad hoc* allocation of charges to non-regulated operations allows them to escape primary responsibility for the BT costs while assigning virtually all of those costs to customers of American Water's monopoly utility operations. This raises the issue of inappropriate subsidization of non-regulated operations by regulated utility customers who have no choice for essential water and wastewater service. *Id.* at 23-25. The Commission should reject IAWC's request that Illinois ratepayers pay for a program from which American Water's non-regulated operations are inexplicably excluded and revise the allocation of costs to Illinois ratepayers after allocation of 12.3% of total costs to American Water's non-regulated operations.

A further indication that the allocation of BT costs to IAWC is overstated is the Northstar audit's statement that in 2010 the allocation of AWWSC BT program costs to IAWC was only 8.9%. Northstar Audit at II-4 (¶IV-7). IAWC did not explain why the allocation of BT costs to IAWC increased between 2010 and the test year. There is no suggestion that the number of customers served by IAWC has increased to justify an increase in allocation. Illinois consumers should not be asked to shoulder both an increase in allocated costs as well as a portion of BT

costs that should be allocated to American Water's non-regulated businesses.

2. IAWC is asking ratepayers to pay a return and profit on Service Company expenses in violation of the SC Agreement that provides that services are provided at cost.

In addition to being an improper allocation to Illinois consumers, the Commission should reject IAWC's request to include \$19 million in BT costs in rate base because BT costs are American Water Works Service Company (AWWSC) costs and therefore are subject to the affiliate Service Company Agreement ("the SC Agreement") approved by the Commission in ICC Docket 04-0595. The Northstar Audit describes the BT project as an AWWSC program, and the vast majority of the contracts for BT are with AWWSC, while none are with IAWC. Northstar Audit at IV-1; AG Ex. 2.0 Rev. at 26. The SC Agreement, which was admitted as AG Cross Exhibit 3, lists essentially the same functions that IAWC witness Twadelle identifies as BT functions. Compare IAWC Ex. 9.00 at 2 with AG Cross Ex. 3 at 2-9.

The SC Agreement states: "All costs of service rendered by Service Company personnel shall be charged to Water Company based on actual time spent by those personnel as reflected in their daily time sheets or other mutually acceptable means of determination." AG Cross Ex. 3 at 9 (¶2.2). IAWC President Teasley and other IAWC witnesses have repeatedly emphasized to the Commission that Service Company services are provided to IAWC "at cost" although the cost includes an extensive list of overhead expenses. IAWC Ex. 1.00 at 26; IAWC Ex. 4.00 at 10; IAWC Ex. 6.00R at 34; Tr. at 85 (Teasley). See also ICC Docket 09-0319, Order at 15, 44 (April 13, 2010)("IAWC also notes that ... the Service Company performs work at cost (with no profit component))."

Despite the provision that AWWSC costs and charges should be provided at cost with no mark-up for profit, IAWC is asking the Commission to allow it to include BT costs in rate base,

which will result in Illinois consumers paying a profit on the cost of these BT systems.⁴ However, the SC Agreement does not authorize AWWSC to shift its cost of service to the rate base of regulated utilities. Article II of the SC Agreement bases charges on “actual time spent,” ¶2.2; direct charges for services, ¶2.3; allocated charges for services, ¶2.4; and cost for support personnel, “as well as the cost of lease payments, depreciation, utilities and other costs associated with leasing office space and equipment.” ¶2.5. AG Cross Ex. 3. IAWC President Teasley testified that she believed that the SC equipment, such as computers or cars are included in SC charges because they are used by SC personnel. Tr. at 86, 103-104. Article II provides for the pass-through of office costs and depreciation, but does not provide that IAWC can move those costs into its rate base and earn a return, or “profit” from such a practice.

The SC Agreement also specifically provides for an “Allowance for Overhead” in Article III. The Agreement specifies how the salaries of officers and employees are to be charged to IAWC, and that “No general overhead of Service Company shall be added to costs incurred for services of non-affiliated consultants employed by the Service Company.” ¶3.1. General overhead is defined in paragraph 3.2 as pension and insurance premiums for SC employees, legal and other fees for services, taxes, other general office supplies and other similar expenses, and interest on working capital. The SC Agreement *does not* include the authority to include Service Company costs or an allocation of Service Company costs in IAWC’s rate base. AG Cross Ex. 3 at ¶3.2.

In contravention of the SC Agreement and its representations to the Commission that there is no “profit” associated with Service Company charges, IAWC is asking the Commission to allow it to earn a profit on Service Company BT costs by adding these costs to rate base. In

⁴ By including these costs in rate base, consumers are charged the weighted average cost of capital that includes a factor for return on equity, which is generally considered a “profit.”

response to questions about why some BT costs were labeled as “O&M” in AG Cross Exhibit 18 (IAWC Response to AG DR 8.12) and whether IAWC is attempting to defer the O&M amounts that occurred prior to the start of the future test year in relation to the BT project, IAWC witness Kerckhove explained:

A. Yes. Illinois has taken the position that we are requesting capital treatment of the amounts for business transformation in this case, and so while amounts were originally recorded as O&M, they were reclassified to construction work in progress.

...

Q. Okay. So these are items that could be expensed in a nonregulated setting, but you're treating them as capital costs in a regulated setting?

A. Yes.

Q. You'd like to treat them as capital costs?

A. Because the utility, the Commission could allow us to treat these costs as capital.

Q. Okay. It could go either way, is that right? It could be treated as capital; it could be treated as expense?

A. That's up to the Commission to decide.

Tr. at 429-430. See also Tr. at 552 (Kerckhove). In fact, each of AG Cross Exhibits 18, 19, and 20 shows O&M in the BT costs IAWC seeks to recover in rate base. These costs would ordinarily be expensed, but IAWC is asking the Commission to include them in rate base.⁵ The fact that O&M are included in the total is not explicitly stated by IAWC. Nevertheless, the Commission should not inadvertently include expenses in rate base, particularly when the SC

⁵ IAWC witness Kerckhove testified that despite the identification of costs as O&M, he did not treat these expenses as “capital” because the Company wants to treat them as capital. Tr. at 431 (“Q. And you haven't made that distinction as to what activity gives rise to what cost? A. We made the distinction that they are all capital.”)

Agreement allows neither rate base treatment of its overhead nor pass-through of O&M as anything except possibly as a component of overhead.

IAWC included \$19 million in rate base as BT costs. The Commission should remove these costs⁶ from rate base because the SC Agreement approved by the Commission does not authorize rate base treatment of this type of cost. Further, the Commission should reject IAWC's implicit request to capitalize costs that American Water treats as O&M from pre-test year periods. See AG Cross Ex. 18, 19, 20.⁷ As IAWC concedes, the Commission is not obligated to treat these costs as capital costs, and ratepayers should not be obligated to pay a return (including a return on equity or profit) on them.

3. The Commission should not allow IAWC to omit the value of cost savings associated with the BT project while charging consumers for BT costs.

The American Water Board of Directors correctly considered the cost savings expected in connection with the BT project. The Northstar Audit, conducted at the direction of the Commission, similarly recognized that cost savings were expected. According to the Northstar Audit, American Water's "most recent estimate of potential BT savings is **CONFIDENTIAL** **END CONFIDENTIAL** per year." Northstar Audit at IV-5. However, the auditors also noted that American Water and IAWC "are still unable to confirm the amount of potential savings that may be realized as a result of BT and are unable to specifically identify how potential savings will be attained." *Id.* Notwithstanding the fact that IAWC has not identified significant cost savings as a result of the BT project, it is asking consumers to pay it a profit on its BT costs.

⁶ The BT costs in rate base are \$19.186 million, and the associated accumulated depreciation and ADIT, resulting in a net rate base decrease of \$17.821 million. The related depreciation expense of \$1.380 million should also be removed. AG Ex. 2.0 Rev. at 44.

⁷ AG Cross Ex. 18 and 20 show actual recorded BT costs for January 2011 through March 2012 and budgeted or projected BT costs from January 2012 through March 2014 respectively.

In Supplemental Testimony, IAWC witnesses identified staff reductions as a savings resulting from the BT project. Specifically, IAWC President Teasley testified that IAWC had a net decrease of 10 employee positions after the implementation of a BT related reorganization in April 2012. Tr. at 91. The test year savings for this staff reduction, however, are reduced by associated severance costs, resulting in a net savings of only \$0.419 million. AG Cross Ex. 7; Tr. at 280. Further, no Business Support Services-Service Company savings are apparent in the test year despite the fact that the BT systems are designed to update and improve the services regularly provided by the Service Company. Although far from clear, it appears that the participation of AWWSC personnel in the multiple (i.e. up to 125) training sessions and meetings about BT has been included in the BT cost that IAWC wants to capitalize. Tr. at 81-82 (Teasley), Tr. at 428-432 (Kerckhove).

IAWC seeks to include \$20,069,826 in rates for Business Support Services - Service Company. IAWC Ex. 5.01 SR, page 1. This is a 10.8% increase from the last rate case, which allowed \$18,114,000 in rates for Service Company costs, limiting the increase from two years earlier to 5%. ICC Docket 09-0319, Order at 47 & App. A (April 13, 2010). Significantly, the increase requested in this docket does not reflect savings from the implementation of the BT project, and in fact, when added to the BT expenditures allocated to IAWC, a further increase in Service Company costs becomes apparent.⁸ The Northstar Audit demonstrates that there are inefficiencies and inaccuracies embedded in the Service Company charges. The growth of this charge notwithstanding the implementation of some BT processes and in the wake of the Northstar Audit is troubling.

The Northstar Audit found that additional controls are necessary and that “remedial

⁸ As discussed in the Order at 26-26 in ICC Docket 09-0319, the Service Company charges increased at an alarming rate since IAWC’s 2002 rate case allowed \$6,843,000 for Management Fees. See *id.* at 33.

action should be focused in four areas:

- Management controls over AWWSC service charges
- Outsourcing opportunities and their potential economic effect,
- overcharges and potential erroneous service charges, and
- AWWSC's BT Program and its potential effect on future service charges.”

Northstar Audit at II-1. The Commission should require IAWC to implement the controls Northstar identified as a condition to any recovery of increased AWWSC charges and costs associated with the BT systems.

The Audit found that more information must be provided by AWWSC in order for IAWC to effectively review Service Company charges, and IAWC President Teasley confirmed that at times she has had to ask for additional information in order to assess charges. Northstar Audit at II-1, Tr. at 105-106. The Audit found that AWWSC “does not consistently adhere” to its second and fourth cost assignment principles: direct charging whenever possible and accurate billing. Northstar Audit at II-1. It also raised concerns about regulated entities subsidizing non-regulated businesses because the non-regulated businesses are not adequately charged for supply chain services. *Id.* at II-2. This mirrors the People’s concern that non-regulated businesses are allocated virtually no BT costs despite the fact that they are part of the American Water corporate structure (and all American Water businesses use “corporate” support) and have a history of using AWWSC services, such as Information Technology. *Id.* at III-5.⁹ See AG Cross Ex. 17.

The auditors also found room for savings. They identified \$3.3 to \$3.5 million of potential annual savings from using competitively outsourced services, including accounting, human resources, executive assistant support, executive management services, and network

⁹ The auditors said: “AWWSC is organized into two levels: corporate and divisional. The corporate level of the organization performs services that can be universally provided to all companies, or functions that are necessary to support the corporate structure.”

services – all areas that will be affected by the BT system. Northstar Audit at II-2. In addition, it identified \$228,416 in errors or overcharges for 2010 alone, including charges for services provided to non-IAWC divisions. *Id.* at II-3-4.

The BT project cannot be considered in isolation. It was developed to make existing processes more efficient, and both the American Water Board and the Commission have the right to expect savings to result. However, in this case, IAWC seeks to increase costs to consumers for the BT project, while AWWSC costs continue to grow and identified savings are small (i.e. \$419,000 due to IAWC Staff reorganization). The result is an imbalance in both the costs and the risks borne by consumers.

Finally, this week, the California Public Utilities Commission decided the same issue of cost savings in regard to the same BT project in a rate case for IAWC's sister affiliate, California-American Water Company. The California PUC adopted the estimated BT savings based on the projected savings provided to American Water's Board of Directors and reduced Cal-Am's revenue requirement accordingly. The California PUC held that:

the estimated benefit or savings identified by Cal-Am should inure to ratepayers during this rate case cycle. Cal-Am states that the estimates are preliminary and of limited predictive value. We understand Cal-Am's concern regarding the accuracy of estimates, but general rate cases are fundamentally based on estimates of future expenses.

Also, the estimates were provided to American Water Work's board of directors, the people who use the information to make decisions affecting the company. We assume that the accuracy of a presentation for the board of directors is at least the same as that of a general rate case filing. And, as Cal-Am's witness stated, there have been no revisions to the estimates of savings since that information was presented to the American Water Work's board of directors in May 2010.⁵⁸

Therefore, we will adopt Cal-Am's estimated savings for 2012, 2013 and 2014, as presented to the American Water Work's board of directors and entered into the

record of this general rate case by DRA. The estimated savings are calculated using figures from the confidential document; however, the figures here do not compromise the confidentiality of that document.

As with most estimates in a general rate case, if Cal-Am realizes greater savings than those identified, Cal-Am retains the savings. If project costs exceed the amount authorized, Cal-Am absorbs them. This equilibrium provides the incentive for Cal-Am to estimate projects accurately, which benefits ratepayers, and reduces costs, which benefits Cal-Am.”

California-American Water Co., Application No. 10-07-007 & 11-09-016, Order at 63-64 (June 14, 2012), available at: http://docs.cpuc.ca.gov/WORD_PDF/FINAL_DECISION/168807.PDF

If, in violation of the SC Agreement approved by the Commission in Docket 04-0595, the Commission allows BT costs in rate base, the expected savings identified by AG witness Smith should also be reflected in rates. In the confidential portion of AG Ex. 2.2, Sch. C-8, AG witness Smith calculated the savings for the various BT systems, adjusted them for the period during which they will be in place during the test year, and assigned 9.90% of the savings to IAWC.¹⁰ These figures, based on American Water expectations, show that the portion of savings attributed to IAWC is \$2.180 million for the test year. AG Ex. 2.2, Sch. C-8. IAWC’s operating expenses should be reduced by this amount.

4. BT Conclusion

IAWC reliance on services from AWWSC has been a source of Commission concern for several years, in large part because of the disproportionate growth of the expense. See ICC Docket 09-0319, Order at 46-49 (April 13, 2010); ICC Docket 07-0507, Order at 30-31 (July 30,

¹⁰ Mr. Smith showed that for IAWC the ERP savings would be in place for the full test year, and equal **CONFIDENTIAL** **END CONFIDENTIAL** and the CIS would be in place for half of the test year, resulting in savings of **CONFIDENTIAL** **END CONFIDENTIAL**. IAWC’s share of these savings is shown on page 2 of AG Ex. 2.2, Sch. C-8.

2008). IAWC is now asking the Commission to approve costs to “transform” the way AWWSC serves IAWC. The SC Agreement that governs the relationship of IAWC and AWWSC provides that IAWC only pays for overhead and time “at cost” and IAWC witnesses have repeatedly asserted that ratepayers do not pay a profit to AWWSC. However, in this docket, IAWC is asking to include AWWSC’s “business transformation” costs in IAWC’s rate base, which will allow AWWSC to earn a return on Service Company expenses. This violates the SC Agreement, and should be rejected. AG Exhibit 2.2, Schedule B-1 removes the BT related costs from rate base and the related accumulated depreciation and ADIT, and Schedule C-7 removes BT related depreciation expense.

In addition, IAWC has not reduced its requested Business Support Service Company charges in this docket despite the completion of at least some of the BT projects in the test year, and IAWC’s savings are less than \$500,000. As a result, consumers are being asked to pay the costs of the new systems but are realizing virtually no the benefits. This is unfair to consumers, and relieves IAWC and AWWSC of any risk or obligation to actually ensure that the BT projects result in efficiencies and savings. The savings American Water internally identified should be allocated and applied to IAWC’s operations in the test year, as shown on AG Exhibit 2.2, Schedule C-8, if any BT costs are to be charged to Illinois consumers.

C. IAWC’s Prepayment Of Service Company Charges Is Not Mandated By The Service Company Agreement And Improperly Increases Its Requested Cash Working Capital.

1. The Commission should adjust IAWC’s cash working capital to remove the effect of purported prepayment to IAWC’s affiliated Service Company.

Cash working capital is the cash needed by the Company to cover its day-to-day operations and reflects the timing of both payments by the Company and receipts of revenue

from customers. AG Ex. 2.0 Rev. at 47; IAWC Ex. 6.00R at 29. In addition to seeking to recover from ratepayers the substantial business support services fee that it pays to AWWSC,¹¹ IAWC's cash working capital request includes cash to cover its practice of paying AWWSC charges *before* services are provided. AG Ex. 2.0 Rev. at 52; IAWC Ex. 6.00R at 33-34.

IAWC claims that it prepays the AWWSC fee based on its agreement with the Service Company, which the Commission approved in ICC Docket 04-0595 IAWC Ex. 6.00 R at 34. IAWC witness Rungren testified that he relies on paragraph 4.1 of the SC Agreement (which was admitted as AG Cross Exhibit 3) as authority for requiring prepayment of AWWSC charges. Tr. at 344. That paragraph does not mandate prepayment. Rather, it states that the Service Company shall render a bill "as soon as practicable after the last day of each month... for all amounts due from Water Company for services and expenses for such month plus an amount equal to the estimated cost of such services and expenses for the current month." *Id.* This language does not require prepayment.

The language quoted from the Service Company Agreement allows the Service Company to bill IAWC "as soon as practicable after the last day of each month... the estimated cost of such services and expenses for the current month." IAWC witness Rungren read this provision to require a hybrid billing process where some charges are estimated and paid in advance and other charges are post-paid. Tr. at 346.¹² Yet in its cash working capital analysis, IAWC increased the cash working capital balance to reflect prepayment and did not specify which AWWSC costs are prepaid and which are post paid. Tr. at 342. The cash working capital calculation should not include pre-payment to IAWC's affiliate Service Company when AWWSC

¹¹ See discussion *supra* at 5.

¹² Mr. Rungren testified: "I believe each monthly payment contains the estimated payment for the current month and then a true-up for the previous month. So you've got an actual component in the true-up and an estimated payment for the current month. That's how I read that."

submits its bill “as soon as practicable,” IAWC is obligated to pay the charges “within a reasonable time after receipt of the bill,” and in fact IAWC pays some charges after services are provided and some charges in advance based on estimates.

IAWC witness Rungren acknowledged that the Service Company agreement is virtually identical with each American Water utility operating company. Tr. at 349. He also testified that he knows that Pennsylvania American Water, one of the largest American Water utilities, is not allowed by the Pennsylvania Public Service Commission to include the cost associated with prepaying Service Company fees in its cash working capital, and that has been the practice in Pennsylvania since the 1990s. Tr. at 348 and AG Cross Ex. 13, para. i. Although Mr. Rungren did not seem to know how other commissions have treated purported prepayment of affiliate services charges,¹³ in 2009, the West Virginia Public Service Commission adopted the argument of the state Consumer Advocate Division (CAD) to apply IAWC’s 12 day payment lag for direct payroll to its Service Company payments, and refused to allow the utility to include payment to AWWSC in its cash working capital calculation. The West Virginia PSC stated:

The Commission is not persuaded that the CAD recommendation is unreasonable or requires actions on the part of the Company that violate its agreement with AWWSC. The agreement allows AWWSC to provide a current bill ‘as soon as practicable’ after the last day of each month. It also provides that AWWSC provide an estimate of the bill for the next month. However, there is no provision for advance payments of the next monthly bill. While WVAWC should not act unreasonably in making payments to AWWSC, a lag comparable with its own payroll lags does not appear to be unreasonable, while an advance payment does appear to be unreasonable. The Commission will adopt this CAD adjustment to the Cash Working Capital.

Case No. 08-0900-W-42, Order at 35-36 (March 25, 2009)(available at:

¹³ Mr. Rungren admitted that he “had no idea” whether states other than Pennsylvania had considered disallowing prepayment of Service Company costs in the lead-lag study, despite his answer to AG Data Request 9.1, admitted as AG Cross Ex. 13. Tr. at 349 (question), 353-355 (answer).

<http://www.psc.state.wv.us/scripts/WebDocket/ViewDocument.cfm?CaseActivityID=262751>, accessed on June 12, 2012).

IAWC presents a “heads we win, tails you lose” argument in support of including the prepayment of AWWSC charges in its cash working capital balance. IAWC witness Rungren argues that in the absence of prepayment of AWWSC charges, IAWC would have to pay “as an overhead the cost incurred by the Service Company to obtain working capital it needed to provide services.” IAWC Ex. 6.00R at 36. However, Mr. Rungren testified on cross-examination that in fact, in Pennsylvania where prepayment was removed from cash working capital for ratemaking purposes, he did not believe there was any effect on the Service Company fees to Pennsylvania American. He testified:

A. Well, as I said before, the Commission ruling in that case didn't change the fees that Pennsylvania was paying to the service company. ...

Q. Okay. So to the best of your knowledge, Pennsylvania-American did not include interest on working capital in its overhead as a result of this decision in Pennsylvania?

A. I don't know. I don't believe so.

Q. But do you know?

A. I don't know.

Tr. at 356-357. Clearly the Commission should take with a generous grain of salt IAWC's argument that Service Company fees will increase if it disallows the effect of prepaying Service Company charges from the cash working capital balance. IAWC cannot demonstrate that one of American Water's largest utilities has increased its charges as a result of the prepayment adjustment, and there is no reason to believe that the charges to Illinois will be any different.

The same adjustment made in Pennsylvania should be made in this case. In order to protect consumers from an inflated rate base due to an overstated cash working capital balance,

AG witness Smith recommended that the Commission apply the same labor lag it uses internally as a reasonable payment lag for payments to IAWC's affiliated Service Company. The Commission should modify the Company's lead lag study to reflect this more reasonable and fair payment lag and to avoid requiring ratepayers to first pre-pay IAWC's affiliate and then pay a return on the cash used to pre-pay the affiliate. This change reduces rate base for the total company by \$1,242,000, as shown on AG Ex. 2.2, Sch. B-4, line 3, "Affiliate billing lag adjustment."

2. The Commission should adjust IAWC's lead-lag study to remove the effect of uncollectibles from the payment lag.

Although IAWC has produced a new lead-lag study for this docket, the new study continues a distortion identified in IAWC's last rate case and which increases the rate base attributable to cash working capital. In ICC Docket 09-0319 the Commission adopted an intervenor adjustment to reduce the payment lag to 21 days, which is the bill payment time specified for residential customers in IAWC's tariffs. AG Ex. 4.0 Rev. at 18. IAWC's revenue collection lag improperly assumes that the Company, *on average*, receives payment from consumers several days after the due date on the bill. This component of the lead-lag study is distorted because IAWC failed to remove the effect of uncollectibles, which by definition have an unusually long collection lag. AG Ex. 4.0 Rev. 17-18.

The Company admitted that "[l]arge balances, outstanding for a long period, result in an actual calculated weighted average collection lag that is longer than 21 days," and that the revenue collection lags it used ranged from 23.52 to 47.05 days." IAWC Ex. 6.00R at 32, 31. In addition to having the effect of assuming that customers on average pay their bills late,¹⁴ IAWC's approach fails to remove the distorting effect of uncollectible accounts, thereby extending the

¹⁴ Under the Commission's Rule 280.90, residential customers have 21 days to pay a bill from the utility and commercial customers have 14 days from the mailing date. 83 Ill. Adm. Code 280.90.

payment lag. Like other utilities, IAWC's rates include a factor for uncollectible accounts, so consumers are already compensating the Company on a regular basis for uncollectible accounts. It is unfair and a form of double counting to include a charge for uncollectibles in rates, and then include a payment lag for uncollectibles in rate base as if the Company were in fact not receiving payment for those same uncollectibles.

The Commission should modify the Company's lead lag study to remove the effect of uncollectibles, which result in a collection lag of greater than 21 days. This change reduces rate base for the total company by \$2,768, as shown on AG Ex. 2.2, Sch. B-4, line 2 "Revenue Collection Lag Adjustment."

D. IAWC Should Not Be Allowed To Include The Unamortized Balance Of The External Audit Cost In Rate Base But Should Treat It As The Commission Treats Rate Case Expense.

As discussed in more detail below at pages 29-33, IAWC asks the Commission to allow it to charge consumers \$1.114 million for a \$392,100 external management audit of affiliated Service Company charges. AG Ex. 2.0 Rev. at 78. In addition to being an excessive charge (including \$722,000 for IAWC's internal, AWWSC, and contract audit related costs), IAWC proposes to treat this expense differently from other rate case related costs, and to include the unamortized balance in rate base.

By including the unamortized balance of this excessive cost in rate base, IAWC is asking consumers to pay a return on both its costs and on the Northstar audit costs. To the extent that IAWC's costs are AWWSC costs (i.e. \$225,000), including these costs in rate base violates the SC Agreement approved in ICC Docket 04-0595, and included in the record as AG Cross Exhibit 3. The AWWSC charges IAWC asserts are associated with the audit are past charges and not part of the test year, and IAWC does not cite to any authority for deferred recovery of this AWWSC cost. The SC Agreement provides the terms for billing and payment of AWWSC charges, and

IAWC should not be able to earn a return on some of those charges by separating them from other AWWSC charges.

The Commission should reject IAWC's proposal and remove the total unamortized balance of \$353,000 from rate base, as shown on AG Exhibit 2.2, Schedule B-7.

E. Accumulated Deferred Income Taxes (ADIT) – The Commission should remove from rate base the non-investor funds associated with the ADIT for the FIN 48 repairs deduction.

As the Commission recently stated, “Generally, ADIT quantifies the income taxes that are deferred when the tax law provides for deductions with respect to an item, in a year other than the year in which the item is treated as an expense for financial reporting purposes. For regulated entities, ADIT is treated as a non-cost source of capital that reduces rate base.” ICC Docket 11-0721, Order at 56, citing *Ameren Illinois Co. v. Ill. Commerce Comm’n*, 2012 IL APP (4th) 100962 at 5, 2012 Ill.App.3d LEXIS 175 (4th Dist. 2012). In this case, IAWC has attempted to treat ADITs as if they are investor supplied funds and earn a return on them. Tr. at 824. The Commission should reject this deviation from the standard treatment of ADITs¹⁵ and reduce rate base by \$1.529 million to reflect non-investor capital available as a result of IAWC's change to its repairs deduction. AG Ex. 2.0 Rev. at 67 & AG Ex. 2.2, Sch. B-6.

IAWC argues that it should not deduct the ADITs associated with the repairs deduction because it has classified this deduction as an “uncertain tax position” under FIN 48. IAWC Ex. 13.00R at 5. IAWC witness Warren explained that “FIN 48 prescribes, for financial reporting purposes, a single standard, a single process, and a single disclosure regime for uncertain tax positions taken by a taxpayer, *i.e.*, tax positions taken by a taxpayer that may be disputed by the

¹⁵ IAWC witness Warren suggests that there are two kinds of deferred taxes that result in non-investor cash being available to the Company: “ADIT loans” and “non-ADIT loans.” IAWC Ex. 13.00R at 6-7. FIN 48 does not use terms like that. AG Ex. 4.0 Rev. at 30. The definition of ADITs used by the Commission and the Illinois courts treats tax savings as non-investor funds available to fund rate base. The fact that the deferred taxes may or will be paid in the future does not affect the fact that the cash is available to fund rate base in any given year.

tax authorities.” *Id.* at 9-10. Mr. Warren further noted that “*for financial reporting purposes*, uncertain tax positions “must be reflected by the company on its balance sheet as a tax liability.” *Id.* at 11 (emphasis added).

IAWC witness Warren recognized, as he must, that deferred taxes are an element of tax expense in every utility because there is always a discrepancy between the tax expense included the cost of service, and what gets paid to the IRS. Tr. at 803-804. As Mr. Warren put it, when the utility retains money that will later be paid to the IRS due to timing differences, and there is a mechanism built into the tax law allowing the taxpayer to defer the tax that otherwise would be paid, the taxpayer has “got the cash.” Tr. at 805. The question before the Commission is whether this non-investor cash, legally retained by the utility under the authority of FIN 48 pending IRS review, is non-investor cash that must be deducted from rate base.

AG witness Smith and Staff witness Kahle agree that the repairs deduction is a tax savings which represent an interest free source of funds from the Federal and State government. AG Ex. 2.0 Rev. at 61-62; Staff Ex. 9.0 at 10. IAWC witness Warren, by contrast, while acknowledging that legally retained tax savings represent non-investor supplied funds, Tr. 803-805, asserts that the Company should be allowed to earn a return on them because they are not “really” ADITs. In addition to inventing an “ADIT” and “non-ADIT” distinction that is found nowhere in the law or in regulatory policy, this is clearly an attempt to use semantics to increase the Company’s rate base and to increase charges to consumers despite the fact that Mr. Warren. The following exchange demonstrates that IAWC’s position is based on the erroneous premise that IAWC should be allowed to earn a return on non-investor capital:

A. If we want to place the Company in the position they would have occupied had they known when

rates were set what was known a year or two years from now when they pay the tax, you wouldn't have reduced rate base by that amount.

Q. Mr. Warren, isn't it correct, though, that during that period of uncertainty...

A. Uh-huh.

Q. ..when you didn't know that you were going to have to pay that tax, the Company had that loan, that money, available to it to fund its operations?

A. It had -- yes.

Q. That was not investor money, correct?

A. And the cost of that, we are talking about an arbitrage between reducing rate base at the weighted overall cost of capital, which is what would happen, and then allowing the Company just to earn the interest. I mean, okay, it is better -- being compensated for the interest is better than nothing. But it is still not making the Company whole because the Company is still better off not having taken the deduction.

Q. So you are saying that the Company should be allowed to earn an investor return on this non-investor supplied capital, isn't that correct?

A. I am saying that in the normal course -- yes, that is what I am saying, exactly. The only non-investor source of capital they don't owe a return on are deferred taxes, and these aren't them.

Tr. at 823-824. Clearly, the Commission should reject a recommendation to retain in rate base non-investor supplied funds.

FIN 48 repairs deductions have been deducted from rate base by regulatory commissions in other states. For example, just this month the Indiana Public Utilities Regulatory rejected an Indiana American request to exclude the FIN 48 repairs deduction ADIT from rate base and stated:

We now address the ratemaking treatment for the FIN 48 balance, which represents the "uncertain" portion of the repairs deductions taken by the Company. In 2008, the Company changed its tax accounting method for repairs. For the test year, the only "uncertain" tax position, and the only item for which Indiana-American has

recorded a FIN 48 Reserve, is for repairs deductions. According to Petitioner's accounting records, the FIN 48 balance on December 31, 2010 was \$9.449 million.

Petitioner asserts that the "uncertain" portion of its repairs deductions should have no effect on its regulatory capital structure. The OUCC argues that repairs deductions result in non-investor supplied capital that should be recognized in the capital structure either as zero cost capital (similar to other ADIT) or as a form of non-investor supplied capital that requires an interest cost.

The money resulting from the lower income taxes that resulted from the repairs deductions claimed by the Company is available for any use to which the Company wants to put it, and is therefore similar to other sources of non-investor supplied capital. Ignoring this source of non-investor supplied capital altogether as Indiana-American advocates is not reasonable. Reflecting the full impact of the repairs deductions, including the "uncertain" portion as non-investor supplied capital is reasonable since the Company has the use of that money and can use it for any use that it wishes.

Indiana American Water Co., Cause No. 44022 (Indiana PURC) Order at 40 (June 6, 2012)(emphasis added). www.in.gov/iurc/files/order_in_cause_No.44022.pdf

Similarly, in a recent West Virginia American Water Company rate case, the West Virginia Public Service Commission also rejected the Company's request to allow shareholders to receive a return on FIN 48 ADITs in rate base. The West Virginia Commission stated:

The Commission recognizes that the capital repairs deduction is essentially new ground for WVAWC with an inherent set of uncertainties until tax returns containing the deduction are finalized. Any tax return, however, carries a level of uncertainty with regard to the final IRS determination of taxable income. WVAWC's proposal to add the FIN 48 reserve to rate base until each year's tax return is cleared and no longer subject to modification by the IRS is unreasonable. If the IRS does not disallow the amount estimated by the Company, customers would not receive the benefit of the deferred tax credits between now and first rate case after tax returns are no longer subject to IRS review and adjustments. WVAWC proposed no mechanism to protect customers if the FIN 48 reserve proved to be too high and, in such case, to compensate customers for the added revenue requirements on excessive rate base they would be paying while awaiting the IRS closing of the tax return review period. ...

Until the uncertainty surrounding the capital repairs deduction is eliminated, WVAWC has the use of the full amount of related ADIT's are properly recorded on the books and it is widely accepted regulatory practice to reduce rate base by recorded deferred tax credits. The Commission believes that it should include total ADIT's without the FIN 48 Offset as a credit against the WVAWC rate base.

West Virginia American Water Co., Case No. 10-0920-W-42T, Order at 29 (April 18, 2011).

The People request that the Commission remove the FIN 48 repairs deduction from IAWC's rate base so that the Company is not permitted to earn a return on non-investor funds. As shown on AG Ex. 2.2, Sch. B-6, this removes \$1,529,000 from rate base.

III. OPERATING INCOME

A. IAWC Under-Estimated Revenues Based On A Faulty Demand Projection That Fails To Incorporate Recent Actual Demand Or The Variability Of Demand And Revenues Among IAWC's Districts.

In developing rates, the appropriate level of projected revenues must be determined so that the new rates accurately recover the revenue requirement. In this docket, IAWC has used a simplistic and ultimately erroneous method to predict its demand and understated its associated revenue in the future test year by \$2,302,388. AG Ex. 1.0 at & AG Ex. 1.03. This adjustment is reflected in AG Ex. 2.2, Schedule C-1 for each operating district. The revenue projection must be corrected to set fair rates.

There are several problems with IAWC's demand and revenue projections. First, IAWC's method for projecting consumption ignores key factors that affect demand forecasting, including population, economic conditions including inflation and household income, changes in water-use technologies, weather and climate, and price. AG Ex. 1.0 at 6. Instead of using well established water demand forecasting methods, IAWC used a limited set of data that was made less representative of actual variability by being reduced to annual averages.

Second, although IAWC claimed to base its analysis on "base consumption" or consumption that is not weather sensitive, it excluded demand data for November and December, reducing the number of months involved in its analysis for six (half a year) to four (only a third of a year). In Illinois, weather sensitive outdoor water use is limited to the summer months, making it appropriate to treat November and December as non-weather sensitive months. AG

Ex. 1.0 at 6-7. IAWC used an improperly small sample of months in its analysis, making the results less reliable. As shown on AG Ex. 1.01, the use of all non-weather sensitive months reduces the size of the change IAWC projects based on an unreasonably restricted data set.

Third, IAWC's analysis averages the demand for each year, ignoring that monthly use varies. Fourth, the effect of using an average of an unreasonably small number of months is compounded by the limited number of years used in the analysis. Mr. Rubin demonstrated that "an unusually high starting point or an unusually low ending point would have a dramatic effect on the analysis" because so few data points are included. AG Ex. 1.0 at 7. It is neither accurate nor fair to consumers to accept a Company analysis that does not follow accepted industry approaches to projecting demand and that has so many data limitations and biases.

To produce a more accurate demand and revenue projection, Mr. Rubin analyzed IAWC's most recent consumption and customer figures for each of the years ending September 30, 2011 and 2012. This more precise projection of revenues is more appropriate for ratemaking, and includes a separately calculated revenue projection for each district. The actual data shows that there is significant variation among the districts. From 2011 to 2012, revenues in some areas increased (Chicago Metro and Pekin) and revenues in other areas (Zone 1 and Lincoln) decreased. AG Ex. 1.0 at 9. Notwithstanding the fact that actual revenues increased in some areas from year to year, Mr. Rubin's recommendation, like the Company's, results in lower total revenues in the test year compared to the year ending September 30, 2012 for all districts except Pekin. However, the Company over-stated the degree of decreased demand and revenues by \$2,302,388. AG Ex. 1.03.

B. The Commission Should Adjust IAWC's Rate Case Expense To Remove Unreasonable Northstar Audit and Other Rate Case Expenses.

1. The Commission Should Reject IAWC's Attempt To Collect Excessive Charges For The Northstar Audit Of AWWSC Charges Ordered By The Commission.

Pursuant to the Commission's order in IAWC's previous rate case, ICC Docket No. 09-0319,¹⁶ Northstar Consulting Group was engaged to conduct a management audit of the fees paid by IAWC to its affiliated service company, AWWSC. In this current case, the Company claims \$1.114 million to cover the costs of this management audit. IAWC Ex. 4.00 at 16. Although the cost of the management audit itself is recoverable under section 8-102 of the Public Utilities Act (220 ILCS 5/8-102), the Company is seeking recovery of multiple costs associated with the audit. Those costs above and beyond the costs of the management audit itself are unreasonable, excessive and should not be recovered.

The Company seeks to recover over 180% more than the actual costs of the audit as its own costs. This requested cost is grossly disproportionate to the \$392,100 cost of the audit itself, is unreasonable, and should be rejected. Although the People do not contest the recovery of the cost of the audit, the Company's attempt to recover an additional \$722,000 -- 1.84 times the cost of the third party audit, is unreasonable.

Merely incurring a cost is not sufficient to justify recovery in rates if that requested cost increase is excessive or unjustified. The Commission must assess whether large increases to expenses are reasonable. *Peoples Gas Light and Coke v. Slattery*, 373 Ill. 31, 66 (1940). In *Slattery*, the Illinois Supreme Court approved a number of Commission adjustments to operating income, including a cost that had greatly increased when the business was taken over by the utility. *Slattery*, 373 Ill. at 66. The Court justified removing 30% of "new business" expense as

¹⁶ Illinois-American Water Company, Proposed general increase in water and sewer rates, ICC Docket No. 09-0319, Final Order at 47 (April 13, 2010).

follows:

“From 1922 to 1932, when the appliance department was operated separately from the utility, the new business expense averaged about \$700,000 per year, but when it was taken over as part of the utility, new business expense increased to over \$1,500,000 per year. We do not think the action of the commission in this respect was unjustified, as, in the very nature of things, a sale of outside articles to promote the sales of a commodity regulated by a utility must be controlled by the commission, as otherwise it would be possible to either raise the operating expenses to unreasonable heights or convert the utility into a mere medium of selling appliances and merchandise not regulated by the commission.”

Slattery, 373 Ill. at 66. Here, IAWC is attempting to recover costs that, as in *Slattery*, are the very types of costs that must be controlled by the Commission.

The details of IAWC’s costs demonstrate that IAWC failed to control its costs even when being audited due to repeated, large cost increases. To start, the Company incurred costs of \$211,000 for an audit consultant in addition to the Northstar auditor. It also identifies \$225,000 for affiliated Service Company labor, \$25,000 for a data room, \$250,000 for additional legal costs, and \$10,000 for travel. IAWC Ex. 4.00 at 16. These costs, over and above the actual cost of the management audit, should be treated as a normal cost of doing business as a regulated public utility, i.e., as O&M expenses incurred between rate cases without any specific Commission authorization for deferral. AG Ex. 4.00 Rev. at 35.

The charges classified as labor expenses are largely for service company employees and the Company has not provided any justification for recovery of these expenses. Only \$1,000 of the charges for employee expense, of the \$261,000 submitted for “internal services,” represent IAWC employees. Tr. at 302. The Company’s attempt to over-recover the Service Company’s labor expenses represents the very types of excessive service company charges that the audit was designed to catch and should be disallowed, particularly when they are so high relative to the total cost of the third party auditor. In addition to affiliated AWWSC support – which

presumably consists of typical AWWSC functions such as accounting, finance and operations (see AG Cross Ex. 3), an outside firm was engaged to manage the audit process at an additional expense of \$211,000. Tr. at 289-90. The Company has not explained how the \$211,000 for an outside firm and the yet higher \$261,000 for internal services are different. The Company has not met its burden of proof to show that its claimed costs are justified and these costs should not be allowed.

Moreover, it is apparent that IAWC was not able to control its costs adequately. IAWC originally projected the costs associated with the audit to be \$150,000 to \$200,000 for outside counsel, \$200,000 to \$300,000 total for outside audit support, and \$50,000 to \$100,000 for internal services, or a range of \$400,000 to \$600,000. AG Cross Ex. 8 (Affidavit of IAWC witness Grubb estimating audit related expenses in ICC Docket 10-0366). The projections were simply revised upwards to reflect the increase in costs. Tr. at 295. The Company has not justified this up to 80% increase in projected cost estimates. These cost run-ups are indicative of a lack of cost control and the dangers of unrestrained use of the affiliated Service Company.

Additionally, IAWC seeks to amortize audit expenses over five years, resulting in a \$222,820 yearly charge and earn “a return on the unamortized balance” of the \$1.114 million. IAWC Ex. 4.00 at 17. If only the charges for the audit were included in rates, there would be little need to amortize the charges over an extended period or include the unamortized balance in rate base. The cost of Service Company study should not be included in rate base to earn a return for shareholders. The cost of the audit is an operating expense and consumers should not be asked to provide a return on that cost, particularly when it has been grossly inflated by excessive and disproportionate internal costs and AWWSC charges. IAWC has emphasized that it pays AWWSC at cost with no profit. Therefore, the Commission should not allow the

Company to both charge consumers an excessive amount under the guise of audit related expenses and include 80% of those costs in rate base to earn a return.

Adding the amortization of this excessive cost into the future test year effectively overloads the future test year with affiliate labor charges. AG Ex. 4.00 Rev. at 36. Taking affiliate service company labor cost from a period prior to the future test year and adding them to the future test year as an amortization on top of the costs that have already been included as budgeted/projected operating expenses, in itself, would produce more than a normal annual amount of such charges in rates. *Id.* The Commission should find these increased AWWSC costs unreasonable. See *Slattery*, 373 Ill. at 66. The \$722,000 IAWC seeks to charge consumers for assisting Northstar in its audit of AWWSC costs should be removed as out of test year charges, and not included in the future test year or amortized for future recovery.

In conclusion, the Commission should reject the Company's attempts to include in rates unreasonable and excessive costs above and beyond the costs of the Commission-ordered management audit. AG Exhibit 2.2, Schedule C-4 shows the removal of \$722,000 and reduces IAWC's requested amortization of the audit related costs by \$144,000. AG Ex. 2.0 at 78.

2. The Commission Should Exclude Affiliated Service Company Labor Costs As Well As Unjustified SFIO Costs From The Rate Case Expense.

The Company also seeks to recover affiliated service company labor costs of \$288,956 and SFIO Consulting costs of \$36,225 as rate case expenses. These costs should be removed and a corresponding adjustment made to the amortization of rate base expenses. The work that IAWC or Service Company personnel perform on the rate case does not require deferral or amortization; it is a normal job function. AG Ex. 2.00 Rev. at 77. Moreover, IAWC and Service Company internal labor costs should be removed because the future test year, as filed, includes a full year of Service Company and IAWC labor costs. Finally, amortizing these costs over future

years would essentially double-count the labor cost for the Company. Accordingly, the Commission should remove this \$288,956 from rates. AG Ex. 2.00 Rev. at 77.

The charges for work done by SFIO Consulting on the rate case should also be removed because the Company has not demonstrated that these costs are reasonable. The services provided by SFIO primarily include review of Company, Staff and intervenor testimony and briefs. As such, this is duplicative of the responsibilities already assigned to Company staff and legal counsel. AG Ex. 4.00 Rev. at 35. In addition, there are no witnesses or work product associated with SFIO that has been submitted to the Commission or other parties in this case.

The expenses for SFIO Consulting and IAWC and Service Company labor costs associated with the rate case are not reasonable rate case expenses and should not be borne by ratepayers. This adjustment along with the adjustment to remove costs associated with the Northstar audit are described in AG Exhibit 2.2, Schedule C-3.

C. The Commission should impute the effect the Section 199 tax deduction on IAWC's taxes on separate return basis for ratemaking purposes.

Although IAWC participates in a consolidated tax return and does not pay federal income taxes separately, it includes a calculation of income taxes as if it filed a separate return equaling \$19.2 million. IAWC Ex. 5.01 SR, page 1. This tax is based on the federal tax rate of 35%. AG Ex. 4.0 Rev. at 44-45. IAWC projects taxable income for the test year.

The federal tax code includes a deduction ("DPAD") for "domestic production activities," also known as the Section 199 deduction. This deduction is for up to 9% of the lesser of taxable income or taxable income produced by domestic production activities such as the collection, storage and treatment of raw water. IAWC Ex. 13.00R at 35-36. IAWC collects, stores, and treats raw water in all of its service areas, although many portions of the Chicago Metro area purchase Lake Michigan water.

If IAWC were a stand-alone taxpayer, there is no question that it would be eligible to take this deduction. IAWC Ex. 13.00R at 35-36. However, because it files a consolidated tax return at the parent level, and the parent has no taxable income, it cannot take the deduction on the consolidated return. *Id.* at 37 & AG Ex. 2.0 Rev. at 91-92. The result is that Illinois ratepayers lose the benefit of a substantial deduction that could reduce the substantial, \$19.2 million stand-alone tax liability IAWC includes in its revenue requirement.

IAWC argues that it cannot take this deduction because its parent has no taxable income. However, *for ratemaking purposes*, IAWC's tax liability is calculated on a stand-alone basis notwithstanding the fact that its actual tax liability is subsumed in its parent's consolidated tax return (which has zero tax liability). As a stand-alone company, IAWC is entitled to the Section 199 deduction because it produces potable water from domestic supply and it has taxable income in the test year. Accordingly, to consistently treat IAWC's ratemaking tax liability as a stand-alone company, the Commission should direct IAWC to incorporate the effect of the Section 199 deduction in its tax expense, calculated on a separate return basis. Unlike the depreciation deduction, the Section 199 deduction does not have a normalization requirement so there is no obstacle to applying in calculating IAWC's stand-alone ratemaking tax expense.

Very recently, on June 7, 2012, the California Public Utilities Commission voted to require California American Water Company ("Cal-Am") to impute the Section 199 deduction in calculating its income tax liability for ratemaking purposes. In that case, as here, the utility had a taxable income ratemaking purposes. The California Public Utilities Commission stated:

We dislike inconsistent treatment of tax positions when the disparate treatment adversely impacts ratepayers, as it does in this case. As noted by TURN, Cal-Am includes the WRAM balances in income for ratemaking purposes, which results in taxable income. However, Cal-Am's calculation of its income for tax reporting purposes excluded the WRAM balances from income, which results in a net operating loss.

The issue here is which of Cal-Am's tax positions should be used to determine whether the DPAD is applicable. In this case, because Cal-Am's tax position for ratemaking purposes resulted in income tax, it is reasonable to apply the DPAD to reduce the income tax obligation for ratemaking purposes.

In D.10-11-034, the Great Oaks Water Company general rate case, the Commission approved DRA's calculation of the DPAD. DRA uses the same methodology here as in the Great Oaks general rate case. DRA's methodology is supported by TURN. Cal-Am proposed a methodology in its initial application, but its rebuttal testimony claims that it is ineligible for the DPAD. As explained above, we disagree. Therefore we find DRA's DPAD methodology reasonable and we adopt it here.

California-American Water Co., Application No. 10-07-007 & 11-09-016, Order at 44 (June 14, 2012), available at: http://docs.cpuc.ca.gov/WORD_PDF/FINAL_DECISION/168807.PDF

Unlike in the CalAm case, here there is no question but that IAWC is present its IAWC tax expense for IAWC on a stand-alone basis, and showing a taxable income. The People request that the Commission direct IAWC to recalculate its income tax expense for ratemaking purposes to include the Section 199 Domestic Production Activities Deduction.

IV. ILLINOIS CONSUMERS ARE LOSING SIGNIFICANT TAX ADVANTAGES DUE TO IAWC'S PARTICIPATION IN AMERICAN WATER'S CONSOLIDATED TAX RETURN, REQUIRING A COMMISSION RULE TO CAPTURE CONSOLIDATED TAX SAVINGS FOR ILLINOIS CONSUMERS.

A. IAWC's failure to take advantage of bonus depreciation unreasonably increases charges to Illinois consumers and puts the interests of IAWC's parent company in conflict the interest of Illinois consumers.

As discussed above, certain tax deductions can result in significant amounts of non-investor supplied funds being available to fund utility operations. In 2010, Congress authorized businesses such as IAWC to take enhanced depreciation expenses to help businesses buy new equipment. AG Ex. 2.0 Rev. at 85. This "bonus depreciation" applies to the period from September 8, 2010 through December 31, 2012. *Id.* The regulatory effect of these deductions is cumulative, so that taking bonus depreciation in these years would reduce IAWC's test year rate

base by increasing ADITs, which are a deduction to rate base (because they are non-investor supplied funds). *Id.* at 85-86.

Both AG witness Smith and IAWC witness Warren agree that the bonus depreciation deduction is subject to normalization requirements. AG Ex. 2.0 Rev. at 40; IAWC Ex. 13.0 at 34-35. Normalization requires that tax and ratemaking treatment of this deduction be coordinated, and prohibits inconsistent treatment. As a result, American Water's decision to forego bonus depreciation cannot be undone by IAWC or by the Commission, and consumers will be unnecessarily and unfairly disadvantaged unless the Commission requires IAWC to share consolidated tax savings with Illinois consumers.

Unlike utilities such as Commonwealth Edison and Ameren, IAWC did not take advantage of the bonus depreciation provisions of the tax law, and therefore IAWC relinquished a substantial ratepayer benefit. As the Commission said in ICC Docket 11-0721 concerning Commonwealth Edison:

Because federal tax laws regarding 2011 allow businesses like ComEd, currently, to depreciate plant additions at 100%, ComEd has use of funds that it would not have otherwise normally have had access to without borrowing or other forms of financing. In effect, ignoring this windfall to ComEd would be to allow ComEd an interest-free loan at the ratepayers' expense for several months.

Order at 59. See also ICC Docket 11-0282, Order at 7 (Jan. 10, 2012). As a result of not taking advantage of bonus depreciation, IAWC has increased the federal income tax expense paid by consumers and increased its rate base, depriving consumers of significant savings.

It is clear that IAWC declined to take advantage of bonus tax depreciation because IAWC's ultimate tax liability is subsumed in the consolidated tax return filed by its parent,

American Water. Unlike IAWC, which has a significant positive income tax expense in the test year, its parent American Water, does not expect to pay any federal taxes for a period of time.¹⁷ Nevertheless, even if American Water had taken the bonus depreciation deduction, and therefore replaced expensive investor funds with no or low cost tax savings, American Water would have still **CONFIDENTIAL** **END CONFIDENTIAL** federal income taxes through **CONFIDENTIAL** **END CONFIDENTIAL**. AG Cross Ex. 25 (confidential).

As AG witness Smith pointed out, in this case “IAWC’s ratepayers appear to be in the worst possible regulatory position concerning federal income taxes.” AG Ex. 2.0 Rev. at 88. Consumers pay a large federal income tax, but IAWC declines to take advantage of available tax savings because, as IAWC witness Warren commented, “For a company whose NOL carryforwards are in danger of expiring unused, in any conventional sense, a decision not to claim additional depreciation deductions would constitute a reasonable business decision.” IAWC Ex. 13.00 SR at 9. Clearly, “decisions adversely affecting IAWC ratepayers, such as the decision not to use 2011 bonus tax depreciation, are being dictated to IAWC by the parent company based on the parent company’s consolidated federal income tax position, from which IAWC ratepayers have derived no benefit.” AG Ex. 2.0 Rev. at 88-89. Of even greater concern, Illinois consumers are asked to forego tax benefits while IAWC’s parent pays no federal income tax at all. *Id.*

Other states with American Water affiliates have addressed this problem by instituting policies that capture for consumers of their state tax benefits enjoyed by the parent company. Of the seven major American Water states, the commissions in Pennsylvania, New Jersey, Indiana,

¹⁷ If the company took advantage of the bonus tax depreciation, it would pay no federal taxes **CONFIDENTIAL** **END CONFIDENTIAL**, and if it did not take advantage of the bonus tax depreciation, it would pay no federal taxes **CONFIDENTIAL** **END CONFIDENTIAL**, due to a “net operating loss” (NOL) carry forward. AG Ex. 2.0 Rev. at 88 and AG Cross Ex. 25 (confidential).

and West Virginia, which represent more than 60% of American Water's regulated revenues, all have adopted a mechanism to capture consolidated tax savings for their state. Tr. at 713, 748, AG Ex. 2.2, Sch. C-8, p. 2. Texas, with smaller American Water operations, also imposes a consolidated tax saving adjustment. Tr. at 713. In Indiana, for more than 20 years the Commission has used a process that reduces the utility's federal income tax expense when a consolidated income tax return is filed. Tr. at 790 (Warren). IAWC witness Warren testified in an Indiana American Water rate case in December, 20 that applied the Indiana approach, resulting in a \$2.2 million reduction in federal income tax. Tr. at 792-793. Illinois American is a larger utility than Indiana American. AG Ex. 2.2, Sch. C-8, p. 2.

IAWC witness Warren discussed the several approaches utilized by the major American Water states to capture consolidated tax savings at Transcript 792-799. However, American Water companies prefer not to make these adjustments, which reduce rates, and they will only do it if directed by a rule or Commission order. Tr. at 798-799. Nonetheless, as Mr. Warren pointed out that these states "determine that there are consolidated tax savings to begin with that are subject to shift, *which is not a proposition that actually has controversy.*" Tr. at 798 (emphasis added). Clearly in Illinois American's case, there are consolidated tax savings that should be shared with consumers, particularly in light of IAWC's failure to take advantage of available tax savings.

Mr. Warren described the Indiana approach in his testimony at pages 791-793 of the transcript as follows:

Q. You compute the Company's long-term debt to equity ratio.

A. Okay.

Q. Then you multiply that by the utility's equity amount, correct?

A. Okay. So far so good.

Q. Then you calculate the parent company's average cost of long-term debt and you multiply that amount by --

A. Two.

Q. By two.

A. Right, by two above. That was my understanding of the process laid out in, what was it, a 1971 Order of the Commission there, something like that.

Q. And so that produces an amount of interest, the tax benefit of which is allocated to the Indiana utility as a reduction to the Indiana utility's income taxes?

A. That is correct.

Q. And do you recall also testifying that this approach resulted in the water utility reducing its federal income tax expense by approximately \$1.4 million?

A. I don't remember the exact number, but it was something -- that was the right order of magnitude, yes.

Q. And then that reduced the revenue requirement by about \$2.2 million?

A. I believe that's the case, yes.

The Indiana approach is based on the *Muncie Remand Order*, 44 PUR4th 340 (1981), on remand from *City of Muncie v. Indiana Public Service Comm'n*, 378 N.E.2d 896 (Ind. Ct. App. 1978). It was recently applied by the Indiana Commission in an Indiana-American Water rate case. *Indiana American Water Co.*, Cause No. 44022 (Indiana PURC) Order at 92 (June 6, 2012). Available at: www.in.gov/iurc/files/order_in_cause_No._44022.pdf

Other states have similarly taken measures to account for consolidated tax savings. Pennsylvania requires that the savings from a consolidated tax return be passed on to the ratepayers, stating: “[W]here a utility realizes federal income tax savings because of its participation in a consolidated return, Pennsylvania law requires that those savings be passed on

to the ratepayers by means of an adjustment to the utility's allowance for tax expense.” *Barasch v. Pennsylvania Public Utility Commission*, 120 Pa.Cmwlth. 292, 548 A.2d 1310, 1311 (1988).¹⁸

New Jersey, when applying a consolidated tax savings adjustment, reasoned that the ratepayers who produce the income that provides the tax benefits should share those benefits. *Matter of Petition of Jersey Cent. Power & Light Co. for Approval of Increased Base Tariff Rates and Charges for Elec. Service*, 146 P.U.R.4th 127 at 135 (1993).¹⁹

In 1973, the Public Service Commission of Tennessee explained why it disallowed \$948,000 for South Central Telephone due to the consolidated tax return claimed by South Central, reasoning that:

“[t]he theory behind the adjustment is that by filing a consolidated income tax return, the Bell System, i.e., AT&T and most of its operating subsidiaries, realizes great tax savings. The commission contends that a ratable portion of these tax savings should be allocated back to the operating companies, e.g., South Central.”

South Central Bell Teleph. Co. v. Tennessee Pub. Service Commission, 100 P.U.R.3d 45 (1973).

These decisions explain why it is unfair to consumers to allow shareholders to retain all of the benefits of tax savings, particularly in those situations where normalization does not capture savings for consumers. In this docket, IAWC has made tax decisions that disadvantage Illinois consumers because its parent does not need the deductions due to its substantial net-operating-

¹ To determine the “actual taxes paid,” PUC uses the “modified effective rate” method. An effective tax rate method calculates the consolidated tax savings by determining the difference between the total of the stand-alone tax liabilities of all of the members of the consolidated group and the tax actually paid after offsetting of income because of consolidation and then allocates those savings among all of the members. The rationale of this method is that, because the parent pays tax at the marginal rate but on an amount of income reduced by consolidated offsetting, the parent, and in turn the subsidiaries, should be viewed as paying at an “effective” tax rate that is below what they would have paid if the tax had been calculated by applying the marginal tax rate to the full income of each member on a stand-alone basis. *Met-Ed Industrial Users Group et al. v. Pa. PUC*, 960 A.2d 189 at 196, fn 6. (Pa. Cmwlth. 2008)

¹⁹ The Board of Regulatory Commissioners, in adopting the rate base adjustment method, stated “*The rate base approach properly compensates ratepayers for the time value of money that is essentially lent cost-free to the holding companies in the form of tax advantages used currently and is consistent with our recent Atlantic Electric decision (Docket No. ER90091090J).*”

loss carry forward. This case presents a clear example of why Illinois should join these other states in addressing the sharing of benefits resulting from a utility filing a consolidated tax return with its parent and affiliated companies.

The People request that the Commission adopt a procedure and analysis so that consumers can participate in the savings when utilities file consolidated tax returns. IAWC witness Warren agreed that shifting consolidated tax savings to the customers of regulated utilities “is not a proposition that actually has controversy,” Tr. at 798. This docket plainly demonstrates that IAWC failed to take of advantage of a substantial tax benefit and cost consumers millions of dollars in rate base deductions as well as decreased taxes, justifying the need to share consolidated tax savings with Illinois consumers. See AG Cross Ex. 25. The Commission should adopt the approach of the Indiana Commission, and order IAWC to apply it in this docket to mitigate the unnecessarily high federal income tax embedded in rates and to mitigate the loss of the rate base deduction that would have resulted had IAWC taken bonus depreciation, as it was entitled to do under federal tax law.

V. THE COMMISSION SHOULD REJECT THE RIDER RAC.

In this third water and wastewater rate increase in six years, the Company proposes a Revenue Adjustment Clause (“RAC”) rider, a radical ratemaking device designed to guarantee revenues without regard to how much water the Company actually delivers and sells. The Commission should reject the Company’s proposed Rider RAC because it contravenes accepted ratemaking principles, and is the same type of prohibited single-issue ratemaking device that has been soundly rejected by Illinois courts. IAWC’s RAC is an unlawful rider that does nothing more than guarantee revenues while shifting costs across customer classes and districts, and ignoring both the quantities of water sold and the wide disparities in production costs across districts. In addition, the Company has not proven that the proposed RAC and its guaranteed

revenues are necessary.

A. Rider RAC is A Flawed and Unnecessary Ratemaking Device Designed to Guarantee the Company's Revenues.

1. Rider RAC Enables the Company to Impose Customer Surcharges No Matter How Much Water it Sells.

IAWC's Rider RAC is a fundamentally flawed revenue-guaranteeing device. As stated by the Company, it is "a mechanism that allows a utility to recover its authorized revenue requirement." IAWC Ex. 4.0 at 17. The proposed rider delivers a predetermined level of revenues to the Company without any consideration of how much water customers actually use. In addition, the proposed RAC applies the very same surcharge to every gallon of water the Company sells regardless of location, despite the extreme variances in costs and charges among districts, customer classes, and usage levels.

Although the Company describes the RAC as a "simple mechanism," (IAWC Ex. 4.00 at 18), calculation of the amount payable to the Company is anything but simple, involving a series of calculations that ultimately lead to the subtraction of "Actual Revenues" from "Target Revenues" – essentially guaranteeing a predetermined level of revenues. Under Rider RAC, the Company would calculate the revenues it receives each year from its customer classes. In a separate calculation, the Company would calculate an offset based on the average production cost per 1,000 gallons, as determined during the most recently concluded base rate case. AG Ex. 1.0 at 14. That average cost is multiplied by the quantity of water sold to affected customer classes during the year being reconciled. That amount is then deducted from the revenues collected to determine revenues net of production costs. This is compared to the revenues net of production costs that the Company was "expected" to receive from customers during its most recent base rate case. The difference (subject to a cap of 5% of revenues each year) is reflected as a surcharge or credit to customers. AG Ex. 1.0 at 14.

IAWC witness Heid stated that Commission-approval of the proposed RAC was necessary because “of volatility in sales volumes, the complexity of projecting pro forma water volumes for use in establishing rates, and the effects on IAWC and customers if actual sales volumes do not ultimately match the projected pro forma sales volumes used to establish the rates.” IAWC Ex. 14.00R at 7-8. The Company’s testimony that it is “entitled” to a certain level of revenue without regard to the volume of water sold (IAWC Ex. 14.00R at 33), however, exposes the erroneous premise and fundamental flaw of the proposed RAC.

The proposed RAC violates the commonly accepted principles that underlie the treatment of revenues for a water utility, including that revenues are always subject to the amount of water sold to customers, the numbers of customers added or lost, or any other volume or demand factor. AG Ex. 1.0 at 15. Instead, it is based exclusively on a predetermined “target revenue.” *Id.* The proposed RAC, therefore, places the risk associated with revenues on the ratepayers, not on shareholders, who are compensated for such risk through a Commission-established rate of return on investment.

As noted by AG witness Scott Rubin, this risk-shifting to ratepayers defeats the very purpose of a regulatory system. Generally speaking, the competitive market does not set prices for regulated water utilities in Illinois. AG Ex. 3.0 at 8. In its simplest terms, because utilities have a captive base of customers and operate under a monopoly franchise, regulators set the price that utilities may charge to that captive base of customers. *Id.* at 8. The very purpose of regulation is to set fair, just and reasonable prices for those customers, not to guarantee that the utility and its investors receive a guaranteed stream of revenue. *Id.* More specifically, regulation fixes the prices that customers pay for their utility service, while the revenues that the utility receives will vary based on the number of customers served and the volume each customer uses.

Id. The regulatory bargain is based on the utility receiving a return on investment well in excess of a risk-free rate of return to compensate it for the risk of consumers buying more or less of its service than projected. *Id.*

With its proposed RAC, the Company attempts to reverse this most basic principle of regulation. The Company's own witness, Mr. Heid, when discussing the underlying purpose of the proposed RAC, suggests that the very purpose of regulation should be to deliver a fixed revenue recovery to the utility and adjust the price to the consumer as the utility sees fit. IAWC Ex. 14.00R at 32-33. Mr. Heid would shift risk to the captive utility customer and strip that customer of the certainty of having a stable and known price.

Expert review of the Company's own data reveals both the tangible impact of this burden being shifted to customers and that the RAC is not a decoupling mechanism designed to address declines in usage. For each of the years that Mr. Rubin reviewed between 2005 and 2010, the Company's "targeted revenues" exceeded actual revenues, meaning ratepayers would incur surcharges each year, amounting to a 5% annual rate increases without the traditional Commission oversight present in a rate case. AG Ex. 1.10. Significantly, in the years 2005 and 2006, *the Company sold more water than projected*, but collected less revenue. AG Ex. 1.0 at 22; AG Ex. 1.10. The Company's revenues in those years fell short of projected revenues by \$13.6 million and \$21.1 million respectively. AG Ex. 1.0 at 22. AG witness Mr. Rubin testified that these revenue shortfalls are likely the result of more water being sold to lower-margin customers in these periods than had been projected. *Id.* This actual data demonstrates that the proposed Rider RAC is not designed to address sales reductions resulting from efficiency efforts, as claimed by the Company, but rather designed to guarantee revenue streams.

While the Company argues that the rider provides symmetrical benefits, noting that the rider provides for customer refunds when actual revenues exceed forecasted revenues in a given year, the record evidence demonstrates the unlikelihood of such a benefit inuring to ratepayers. For each of the years analyzed by Mr. Rubin, the Company failed to meet its targeted revenues *despite selling more water than it had projected*. Had Rider RAC been in effect, ratepayers would not have seen a single refund. *Id.* Therefore, despite the so-called symmetrical aspect of the rider, the Company's own data demonstrates that ratepayers are more likely pay surcharges to ensure the Company reaches its guaranteed level of revenues even when IAWC sells more water than it had projected. *Id.*

Rider RAC does more than “decouple” usage from revenues. It also shifts costs among customer groups and usage levels so that even in years where usage is constant or increases, the RAC would lead to surcharges. This Rider is not designed to respond to usage changes, but to revenue changes.

2. Rider RAC Ignores Differences in Production Costs Among Service Areas.

A key design flaw of the proposed Rider RAC is that it ignores a more than 400% difference in production costs from one location to another in the Company's service territory. AG witness Mr. Rubin analyzed production costs across locations in the Company's service territory using the Company's own data, and uncovered significant variations among rate areas. AG Ex. 1.0 at 19. Production costs, a vital variable that the RAC fails to acknowledge, range from a high of 52.43 cents to a low of 9.88 cents per 1,000 gallons as shown below. *Id.*

Residential margin per 1,000 gallons under IAWC proposed rates, by rate area			
Rate Area	Proposed rate	Production cost	Margin
Zone 1	\$5.6995	\$0.5243	\$5.1752
Chicago Metro	\$3.8664	\$0.0988	\$3.7676
Lincoln	\$4.9599	\$0.3311	\$4.6288
Pekin	\$3.1333	\$0.1495	\$2.9838

The proposed RAC is based on the margin (or mark-up) between the rate per unit of water (typically ccf or 1,000 gallons) to customers and the Company's production costs per unit of water, both of which vary widely. *Id.* at 19. The varying rates, production costs, and margins shown in the table above demonstrate that the RAC is not a "decoupling" mechanism in the traditional sense of the word, but rather is a faulty ratemaking tool that undermines cost allocation, rate design, and the fundamental relationship between usage and revenue. *Id.* at 20.

These sizable rate, production cost, and margin variances between rate areas will ultimately impact the calculation of the Company's proposed RAC, even if the Company does not sell less water. *Id.* As an example, if sales were to decline by 1 million gallons in Zone 1, the Company would "lose" \$5,175 in margin. *Id.* However, if sales increased by exactly the same 1 million gallons in Pekin, the Company would "gain" \$2,984. *Id.* Thus, under the RAC revenue recovery mechanism, customers would be assessed a surcharge even though the Company sold exactly the same amount of water as it projected merely because the water was sold in a different location.²⁰ Variations in the level of sales among districts – not reduced overall usage – drives

²⁰ In the simplified example provided, that "loss" would be \$2,191.

the RAC calculation.

The proposed RAC also ignores the effects of a shift in usage among customer classes, resulting in ratepayers paying surcharges even if the Company sells as much water overall as projected. The Company's present and proposed rates contain declining block rates for large commercial, public, and industrial customers, meaning that margins are lower from high-usage, non-residential customers than for residential customers in the same rate area. For example, assume that non-residential consumption increased and at the same time residential consumption decreased by exactly the same amount of water. AG Ex. 1.0 at 20. Even though the Company sold the same amount of water, under the proposed RAC, its total margin would decrease due to the lower non-residential margins. *Id.* In that situation, ratepayers would pay more to cover the Company's guaranteed revenue despite selling an identical amount of water in total and the lower costs associated with large volume usage. As Mr. Rubin testified, "this is not an appropriate use of the ratemaking process. Customers should not be required to guarantee revenues and insulate a utility from the effects of changes in consumption." AG Ex. 1.0 at 20-21.

Another serious flaw of this proposed revenue-generating device is that it does not distinguish the recovery of revenues based on the source of the water. *Id.* at 22. As an example, Chicago Metro customers, who receive purchased water rather than water produced by the Company, would be responsible for paying the purchased water surcharge as well as any RAC surcharge based on the difference in revenues net of production costs in the non-purchased water rate areas. *Id.*

3. Rider RAC Is Not Financially Necessary.

Another reason for Commission rejection of the rider is that the Company failed to prove that such an extreme and unusual ratemaking device is financially necessary. In fact, the

Company provided questionable evidence as to declining water usage and no financial evidence that the test year demand levels would not enable it to recover its costs of providing safe and reliable service and provide an opportunity to earn a reasonable return. Despite repeatedly claiming the need for this guaranteed revenue stream, the Company relies primarily on its repeated statements that it is entitled to the additional revenues the RAC would generate rather than evidence of sustained financial hardship.

The Company relies heavily on statements and calculations that it is experiencing a downward trend in residential water *usage* that averages about a 1.9% decline each year. See, e.g., IAWC Ex. 8.00 at 4. But the evidence shows that the Company's dire projections are based on flawed and overly-simplified analyses. In projecting its consumption levels, the Company did not consider a large enough sample of data and failed to account for major influences in water demand forecasting, including population, economic factors, changes in water-using appliances, weather, climate, price, and conservation programs. AG Ex. 1.0 at 7-8, citing to R. Bruce Billings and C. Vaughan Jones, *Forecasting Urban Water Demand*, (AWWA 1996), pp. 4-5 and Thomas Dumm, *Sound Water-Demand Forecasts are Critical to Water Resources Planning*, Opflow (AWWA), Dec. 2011, p. 2. See also pages 27-29 above. The bases for the Company's statements about declining usage are therefore unreliable and should be rejected.

Likewise, the Company's statements of a projected 1.9% annual declining usage trend are similarly flawed. Although there appears to be a currently declining long-term consumption trend, this does not translate to a year-after-year reduction in consumption or a reduction in total revenue. As is true in any long-term forecast, there will be year to year fluctuations. AG Ex. 1.0 at 8. Eventually, the trend will level off as more homes become equipped with efficient fixtures and appliances. *Id.* At no point will this trend line reach zero because there will always be some

demand for water. Until that potentially theoretical date when the demand trend does level off, however, a rate case is the appropriate forum in which to determine the Company's revenue requirements. IAWC has been seeking rate changes every two years and already has an infrastructure rider (Rider QIPS) reducing the time during which its demand projections will be in place and covering its investment needs. These regulatory tools already address any reduction in demand and need for revenue. An automatic revenue guarantee is unnecessary and redundant.

This identical issue was rejected by the Indiana Utility Regulatory Commission ("IURC") earlier this month in a rate case involving the Company's affiliate, Indiana American Water Company, where Company witness Heid made similar arguments on the downward trends of customer usage. The IURC determined:

While [Indiana-American's] evidence may suggest a historical downward trend in residential customer usage, we do not agree that such a trend is sufficiently predictive of future usage to meet the fixed, known, and measurable standard.

*** In addition, [Indiana-American's] request lies solely on the argument that its total revenues will decline based on a decline in per customer usage. Petitioner's analysis does not take into account other sources of revenues that might offset the decline, for example growth in the number of residential customers, increased usage due to weather, and the possibility of increased usage by other customer classes. Further, because Petitioner has traditionally filed base rate cases every two years and anticipates continuing to do the same, any change in actual usage from rate case to rate case is captured on a regular basis and reflected in Petitioner's base rates.²¹

Indiana American Water Co., Cause No. 44022 (Indiana PURC) Order at 61 (June 6, 2012)(emphasis added). www.in.gov/iurc/files/order_in_cause_No._44022.pdf

As in Indiana, the Commission should reject the Company's flawed arguments and the Company's proposed RAC.

The Company's alleged financial justification for the rider also inappropriately ignores

²¹ Petition of Indiana-American Water Company, inc. for Authority to Increase its Rates and Charges for Water and Sewer Utility Service and For Approval of New Schedules of Rates and Charges Applicable Thereto, Indiana Utility Regulatory Commission, Cause No. 44022, Final Order at 61 (June 6, 2012).

the reduced risk to shareholders a revenue guarantee mechanism like the RAC provides the Company. IAWC witness Pauline Ahern, an expert on common equity cost rates and fair rates of return, argued that there was no way to quantify adjustments to risk premiums and return on equity as a result of the RAC. IAWC Ex. 10.00R at 20-1. That position belies the Company's argument that it needs the RAC to address revenue risk and exposes the RAC as nothing more than a revenue guarantee for IAWC shareholders at ratepayer expense.

Finally, the Company's claim that it is necessary to implement the RAC due to variability in weather should likewise be rejected. The People simply note that this is a variable that has always existed in the water industry and in other utility industries as well.²² There is no evidence in the record that the utility could predict weather more accurately in the past, necessitating the proposed RAC. The Commission should reject this unreasonable and extraordinary attempt to guarantee revenue to investors.

B. Rider RAC Violates the Commission's Test Year Rules and Established Ratemaking Principles.

In addition to a lack of evidence supporting adoption of this revenue-guaranteeing device, the proposed Rider RAC violates the Commission's test year rules. A necessary component of setting utility rates is the synchronized examination of each aspect of a utility's cost of service and each source of revenue. AG Ex. 1.0 at 16-17. Otherwise known as the "matching principle," this is a fundamental principle of ratemaking. *Id.*, citing Leonard Saul Goodman, *The Process of Ratemaking* (1998), vol. II, p. 735.

The matching principle is the foundation for using a test year in rate cases, and has been described as follows:

"If the utility proposes a change, particularly a major change, in the test year rate base, it is required also to consider the related

²² Both the gas and the electric utility industries' demand levels are weather sensitive.

changes in other costs or in revenue. Additional investments may result in efficiencies that reduce operating costs or quality improvements that will increase sales. Unless the utility shows that it has taken such matters into account, its revenue requirement is likely to be out of balance or overstated.” AG Ex. 1.0 at 16-17, quoting Leonard Saul Goodman, *The Process of Ratemaking* (1998), vol. II, p. 735.

By way of example, if a utility replaces a piece of equipment nearing the end of its useful life, it might increase rate base and depreciation expense, but it would also, at the same time, reduce maintenance expenses or produce other cost savings (such as reducing losses). AG Ex. 1.0 at 17. In order to keep costs synchronized, several adjustments may have to be made to rate base, depreciation expense, expenses, working capital, and taxes. *Id.* The proposed RAC fails to make these necessary adjustments, which could result in the company understating revenue or overstating expenses, violating the very purpose of test-year review and causing the ratepayers to overpay for service. See *Business and Professional People for Public Interest v. Illinois Commerce Com'n*, 146 Ill.2d 175, 239 (1991).

The proposed RAC ignores the established relationship between utility rates and levels of cost and investment, contravening established ratemaking practice and shifting unnecessary risk to the ratepayers. Under Parts 285 and 287 of the Commission’s rules, a utility seeking to increase revenues must file a rate case using a proposed test year if it wants to increase revenues by more than 1%, the purpose of which is to require the utility to match revenues, expenses, rate base, and capital costs to the same time period. See 83 Ill. Adm. Code 285.120(a). As noted by AG witness Rubin, estimating sales is a key component of the ratemaking equation, and the variability in demand provides utilities with the incentive to achieve efficiencies (when sales decline) and the opportunity to exceed the allowed return on investment (when sales increase).

A revenue requirement established in a rate case represents the Commission’s best

estimate of revenues that a utility needs to both recover its costs and earn a reasonable profit. While rates are set based on the specific revenue requirement set in a rate case, monopoly regulation in no way assumes that utility expenses and revenues will remain static or that the utility is *guaranteed* a certain level of revenues. The opposite is true: expenses, revenues and the cost of capital are inherently dynamic and ever-changing. Rate of return regulation in Illinois, a key part of the regulatory bargain, sets rates based on prudently incurred and reasonable expenses based on a test year that serves as a snapshot in time of the utility's revenue needs, including a reasonable return on the utility's rate base. *See* 83 Ill.Admin.Code Part 287, *gen'ly*. When rates are set using a designated revenue requirement based on the test year expense and revenue levels, utilities are given the *opportunity*, not a guarantee, of earning a designated profit level.

For the public utility, a "just and reasonable" rate established through the test year process "will permit it to earn a return on the value of the property which it employs for the convenience of the public equal to that generally being made . . . on investments in other business undertakings which are attended by corresponding risks and uncertainties." *Bluefield Waterworks & I. Co. v. Public Serv. Comm'n*, 262 U.S. 679, 692 (1922) ("*Bluefield*"). It is a rate that "should be adequate, under efficient and economical management, to . . . enable [the utility] to raise the money necessary for the proper discharge of its public duties." *Bluefield*, 262 U.S. at 693.

A "just and reasonable" rate, however, "*does not insure* that the business shall produce net revenues." *Hope Natural Gas Co.*, 320 U.S. at 610 (quoting *Fed. Power Comm'n v. Natural Gas Pipeline Co.*, 315 U.S. 575, 590 (1942) (emphasis added)). Public utilities are *not* insulated from market realities. *See Market St. Ry. Co. v. R.R. Comm'n*, 324 U.S. 548, 568 (1945) ("Even

monopolies must sell their services in a market where there is competition for the consumer's dollar and the price of a commodity affects its demand and use.”). Rider RAC contradicts these fundamental principles. It does not recognize that rates based on a test year are presumed to be adequate, with efficient management, to enable necessary revenue to be raised, *Bluefield*, 262 U.S. at 693. Rather, RAC would produce *guaranteed revenues* regardless of efficient management. Rider RAC's purpose is to insure that the Company produces net revenues, *contra Hope Gas*, 320 U.S. at 610, a guarantee that impermissibly favors IAWC, while improperly insulating the public utility monopoly from market realities, without any legal precedent.

In short, the traditional rate-setting process was designed to *allow* a utility the opportunity to earn a reasonable rate of return on investment; a utility has *never* been guaranteed a specific “margin revenue” level. While rates should never be set so low as to be confiscatory to the utility, the Illinois Courts have explained that, “within this outer boundary, if the rightful expectations of the investor are not compatible with those of the consuming public, it is the latter which must prevail.” *Citizens Utility Board v. Ill. Commerce Comm’n*, 276 Ill. App. 3d at 737 (quoting *Camelot Utils., Inc. v. Ill. Commerce Comm’n*, 51 Ill. App. 3d 5, 10 (3rd Dist. 1977) (“*Camelot*”)).

For these reasons, Rider RAC should be rejected.

C. Rider RAC Constitutes Unlawful Single-Issue Ratemaking.

IAWC asserts that it needs Rider RAC in order to ensure cost recovery, and assumes that it is entitled to a *guaranteed* specific revenue level until rates are reset in a future rate case. But riders are a mechanism to be used in very specific circumstances, to recover very specific kinds of expenses. Using a rider to guarantee a designated level of revenues violates the rules governing riders established by the Illinois courts.

As a general rule, an automatic rate adjustment mechanism should be used, if at all, only for significant *expenses* that are volatile and largely outside of the utility's control. The Illinois Appellate Court has made this clear in the recently issued *Commonwealth Edison Co. v. Illinois Commerce Comm'n*, (“*ComEd*”), 937 N.E.2d 685 (2d Dist. 2010). In *ComEd*, the Court held that because riders always permit direct recovery of a single cost, rather than incorporating that cost into the aggregate calculation of the revenue requirement, they always pose, at the very least, a “danger of single-issue ratemaking.” *City of Chicago II*, 281 Ill. App. 3d at 628; *see also ComEd*, 937 N.E.2d at 708 (“Because a rider is a method of single-issue ratemaking, by nature, it is not allowed absent a showing of exceptional circumstances.”). Every Illinois court to review a non-statutory Commission-approved rider has judged it against the limits established by the rule against single-issue ratemaking.

In *ComEd*, the court comprehensively reviewed all of the Illinois judicial decisions involving riders, and identified the general principles that bind these cases into a uniform legal standard. The Court concluded that exceptional circumstances necessary to justify a rider arise only when the proposed rider is designed to “recover a particular cost if (1) the *cost* is imposed upon the utility by an external circumstance over which the utility has no control and (2) the *cost* does not affect the utility's revenue requirement.” *Id.* at 687 (emphasis added). The Court further held:

In other words, a rider is appropriate only if the utility cannot influence the cost (*Citizens Utility Board*, 166 Ill.2d at 138 [‘a rider mechanism is effective and appropriate for cost recovery when a utility is faced with unexpected, volatile, or fluctuating expenses’] and the expense is a pass-through item that does not change *other expenses or increase income* (*Citizens Utility Board*, 166 Ill.2d at 138 (*a valid rider has no ‘direct impact on the utility’s rate of return’*)).

Id. at 687 (emphasis added).

In its review of Illinois law, the Court reconciled and distinguished past cases affirming Commission approval of riders that involved the recovery of expenses related to the purchase of natural gas, federally-mandated environmental remediation costs, and municipalities' franchise fees. The Court concluded:

In each instance, the expense was an externality imposed on the utility, and the expense was passed directly on to the consumer without affecting the utility's return on investment.

Id. at 688. Rider RAC, as proposed by the Company, is inconsistent with these parameters. First, recovery of designated revenue forecasts is not recovery of a pass-through "expense." Second, the sole purpose of the rider is to increase income (when revenues are less than expected), thereby directly impact the utility's rate of return.

While Rider RAC addresses production costs in addition to revenues, changes in usage levels are not exceptional circumstances and variable production costs are not unique costs as defined by the *ComEd* Court that justify rider treatment. While IAWC witness Mr. Heid testified that the Company needs the RAC Rider because there is a risk that changes in water sales could result in the Company failing to recover the revenues that it attributes to its fixed costs, "[t]his concern is nothing new for a water utility." AG Ex. 3.0 at 7; IAWC Ex. 14.0R at 7-9.

As AG witness Mr. Rubin noted, for decades water utilities have operated under a regulatory system whereby their revenues are determined by the volume of water used by the customer. AG Ex. 3.0 at 7. All the while, water utilities have dealt with the variables presented by the number of people living in a household, weather, efficiency improvements in appliances and plumbing fixtures, and economic conditions. AG Ex. 3.0 at 7. The Company now argues that these same commonplace variables require the Commission to take the extraordinary step of approving a rider that guarantees revenues irrespective of weather, usage, economy or any other

external factor. IAWC Ex. 14.0R at 7-9. These variables represent the well-known risks facing utility shareholders and are a primary reason water utilities receive a higher rate of return than the average consumer receives on lower risk investments. AG Ex. 4.0 at 15. The Company has failed to demonstrate that it is facing extraordinary circumstances or an unusual cost that justifies this extraordinary revenue guarantee.

Rider RAC is unlawful because its purpose of guaranteeing revenue streams has the effect of adjusting utility rates based solely upon changes in revenues, without regard to other changes in the utility's rate base, operating expenses, customer numbers or the cost of capital. The RAC assumes, inappropriately, that the utility's financial health is dependent on ensuring that an established revenue level is maintained between rate cases. This unjustified premise for the RAC revenue-recovery mechanism ignores the fact that utility expenses, rate base, customer numbers and cost of capital are dynamic and ever-changing. For example, the RAC fails to properly account for (1) changes in operating expenses, such as labor force reductions and operating efficiencies gained through new technology; (2) changes in the rate base; and (3) changes in the cost of capital – all elements that affect a utility's revenue requirement. Rider RAC changes future customer rates to account for changes in only a single element of the revenue requirement formula – forecasted customer revenues, while ignoring all other changes.

The Company argues that decreasing demand for water is a new risk. However, as noted above, this risk is not as dire as the Company suggests because demand, while currently trending downward, fluctuates up and down from year to year. The Company's long term projections are not based on sufficient data to be reliable and do not justify an automatic adjustment.

In rejecting the ComEd rider (despite Commission approval), the Illinois Appellate Court noted the dangers a single-issue ratemaking rider “because it considers changes in isolation,

thereby ignoring potentially offsetting considerations and risking understatement or overstatement of the overall revenue requirement.” *ComEd*, 405 Ill. App. 3d at 411, citing *Citizens Utility Board v. Illinois Commerce Com’n*, 166 Ill. 2d 111, 137 (1995). Here, the Company is asking for approval of a rider that, similar to the ComEd rider, allows changes in revenues in isolation from other changes in costs or operations. The proposed RAC ignores potentially offsetting considerations, such as the unit production costs or the amount of water sold in a district by district or class by class basis. It considers one and only one issue: *revenue*. By guaranteeing that the Company recovers all approved revenues without regard to changes in costs or other aspects of operation, the proposed RAC violates the prohibition against single issue ratemaking and should be rejected.

In addition, the Company’s proposed RAC bears similarities to the rider invalidated by the court in *A. Finkl & Sons v. Illinois Commerce Com’n*, 250 Ill. App. 3d 317 (First Dist. 1993). In *Finkl*, the Illinois Appellate Court reversed the Commission’s approval of a ComEd rider that allowed ComEd to recover revenue lost as a result of mandatory conservation and “demand-side management” programs. *Id.* In rejecting the single-issue ratemaking device, the court found that it failed to consider various aggregate costs and revenues. *Id.* at 328. In its rejection of recovering lost revenues through a rider, the Court stated:

Requiring ratepayers to bear the expense of services they avoid due to conservation or DSM programs is not only incredible, but runs afoul of basic ratemaking principles. The Act requires that rates be set which “accurately reflect the long-term cost of such services and which are equitable to all citizens.” (Ill.Rev.Stat.1989, ch. 111 2/3, par. 1-102 (now 220 ILCS 5/1-102 (West 1992)) (section 1-102).) Both in *Illinois Bell Telephone Co. v. Illinois Commerce Comm’n* (1973), 55 Ill.2d 461, 483, 303 N.E.2d 364, and in *Candlewick Lake Utilities Co. v. Illinois Commerce Comm’n* (1983), 122 Ill.App.3d 219, 227, 77 Ill.Dec. 626, 460 N.E.2d 1190, the courts have asserted that ratepayers are not to pay certain costs unless they directly benefit from them. The lost revenue charge

here does not reflect the cost of providing electric service, does not reflect a cost that benefits ratepayers and, further, adds to Edison's revenues without regard to whether Edison's demand or revenues increased because of factors unrelated to DSM programs. This is yet another basis for reversal.

Finkl, 250 Ill.App.3d at 329 .

Like the unlawful rider in *Finkl*, which sought to guard against revenue loss, Rider RAC tracks consumer revenues against an artificial “baseline” level of revenues established in the rate case. It recoups revenue whenever consumption falls below that baseline level, *regardless* of whether the revenue after operating costs *as a whole* provides the IAWC with a rate of return that meets or exceeds the rates the Commission approved in this case. Here, the People have established that, under the proposed RAC, ratepayers will be guaranteeing revenue without regard to whether the shortfalls are the result of rate design, weather, economic conditions, the types of appliances and plumbing fixtures available in the marketplace or efficiency efforts, or likewise whether other changes in costs and revenues offset those revenue losses. *Finkl* further demonstrates that the proposed RAC should be rejected because it authorizes a charge for service *not* taken as well as because it is prohibited single-issue ratemaking.

D. The Company’s Comparisons to Other Approved Riders Are Distinguishable.

The Company attempts to compare this proposed revenue-guaranteeing device with riders that have been approved in other jurisdictions or other Commission dockets. See, *e.g.*, IAWC Ex. 4.00 at 19. However, for the reasons stated below, these other riders are distinguishable and should not be considered persuasive by the Commission.

IAWC witness Heid refers to tariffs in place in both New York and California. IAWC Ex. 14.00SR (Rev.) at 10. However, the tariffs in place in both New York and California were adopted as part of comprehensive and significant efforts to encourage the water utilities to be

actively involved in “aggressive” water conservation programs. AG Ex. 1.0 at 15. In California, these programs included adopting inclining block rates and seasonal rates that were “expressly designed to depress the level of sales.” *Id.* In essence, the Commissions in those states did not want to penalize the utilities for the State’s mandated, aggressive water conservation programs, and allowed the revenue requirement to be decoupled from the volume of water sold. *Id.*

Here, however, the Company has not offered a similar rationale for requesting that its captive base of customers pay for a guaranteed revenue stream. Illinois is not engaging in any, let alone “aggressive,” mandatory water conservation efforts as found in California or New York. *Id.* Although the Company refers to declining usage, it offers no efficiency or conservation programs similar to those in New York or California. Rather, according to an analysis by Mr. Rubin, the Company continues to propose declining block rates for its largest customers, effectively encouraging more consumption of water at lower rates for those large users. *Id.* Even if it were a valid decoupling device, the proposed RAC has no justification absent an “aggressive” mandatory conservation program in place.

The Company also attempts to draw comparisons between its RAC and the volume balancing adjustment (Rider VBA) approved by the Commission in ICC Docket No. 07-0241/07-0242 (cons.) and continued in No. 11-0280/11-0281 (cons.). IAWC Ex. 14.00SR (Rev.) at 10. As a threshold matter, the lawfulness of the Commission’s approval of Rider VBA has been challenged by the People in the Second District Appellate Court, and that appeal is pending. Putting aside the issue of whether approval of Rider VBA was legal, the Commission made it clear in approving the pilot rider that it believed historically high natural gas prices, warm weather trends, and, in particular, the addition of an energy efficiency program, required a regulatory response to the potential for these phenomena to depress Residential and General

Service (Rate 2) rate class revenues.²³ In its Order in Docket No. 11-0280/11-0281, the Commission cited, among other reasons for adopting the rider, that the Companies were experiencing declining load attributable to energy efficiency programs required under Section 8-104 of the Act. Here, the Company offers no similar rationale for approval of this rider. Rather, the Company maintains its original stance that it is “entitled” to its revenue irrespective of consumer usage or company costs.

E. IAWC’s Proposed Use Of Information Sheets To Impose RAC Surcharges Limits Commission Review And Exposes Consumers To Erroneous Charges.

The Company proposed to automatically assess the RAC surcharge (or credit) upon filing an “information sheet.” While an information sheet filing has been used to change purchased water and purchased gas charges as well as QIPS charges, a reconciliation of those charges and revenues is conducted every year. IAWC’s proposed procedure would expose consumers to multiple changing rates – QIPS, purchased water, RAC to name the key ones – with after-the-fact review, raising the risk of having rates yo-yo up and down as reconciliations adjust rates from prior years and adjustments for new rates overlap or are delayed.²⁴

The purposes for which a water utility may file an information sheet are referenced in section 8-306(c) of the Public Utilities Act, which requires water utilities to notify consumers when rates are changed pursuant to a Section 9-201 rate case or an information sheet. 220 ILCS 5/8-306(c). Section 8-306(c) recognizes that information sheets are allowed for a purchased water surcharge, purchased sewer treatment surcharge, or qualifying infrastructure plant

²³ *Peoples Gas Light & Coke Company, North Shore Gas Company -- Proposed General Increase in Natural Gas Rates*. Illinois Commerce Commission, Docket Nos. 07-0241 and 07-0242 (cons.), Final Order (February 5, 2008) at 150-152.

²⁴ Due to issues concerning IAWC’s purchased water reconciliations, the reconciliations for 2009, 2010, and 2011 have not yet begun, although the rate adjustments have been implemented through information sheets. See ICC Dockets 10-0203, 11-0265, and 12-0200. Similarly, there are pending QIP reconciliations covering 2010 and 2011. See ICC Docket 11-0264 and 12-0201. Adding another reconciliation to IAWC’s rates will further complicate rates as well as burden the Commission with additional rate filings and reconciliations.

surcharge. It is inappropriate to expand that list of automatic rate adjustments in light of the legislature's specific requirement that consumers must be notified if the enumerated information sheets change rates.

For all of the reasons stated above, the Commission should reject the Company's proposed Revenue Adjustment Clause.

VI. RATE DESIGN – THE COMMISSION SHOULD REJECT IAWC'S PROPOSED CUSTOMER CHARGES BECAUSE THEY IMPROPERLY OVER-RECOVER CUSTOMER COSTS.

IAWC submitted a cost of service study based on the base-extra capacity method. IAWC Ex. 11.0 at 5. As part of that study, it developed customer related costs, which neither the Staff witness nor AG witness Scott Rubin contested. However, the Company requests customer *charges* that are excessive, and that over-collect customer costs by \$10.76 million. AG Ex. 3.0 at 10; See also Staff Ex. 12.0 at 6 (customer charges recover 117.99% of customer costs). The Commission should not allow the Company to recover non-customer related costs through unnecessarily high customer charges.

On rebuttal, AG witness Rubin explained that IAWC's residential (5/8") customer charges should be increased to no more than \$15.20 in Zone 1 and Chicago Metro, and Pekin, and \$12.85 for South Beloit and Lincoln in order to collect the appropriate amount of revenue. AG Ex. 3.03. Mr. Rubin's rate design maintains consistency by establishing only two customer charge rate levels while limiting the increases in areas that currently have substantially lower customer charges.²⁵ Mr. Rubin's recommendation is cost base, recovering only \$135,000 more than the Company's calculated customer costs, whereas the Company's proposed rate design

²⁵The customer charges in Lincoln and South Beloit are currently \$10.50, resulting in a disproportionately high 22.38% increase in these districts. The customer charges in Zone 1 and Pekin are \$14.50, resulting in an increase of only 4.88% whereas Chicago Metro's \$13.50 customer charge would increase by 12.6%. See AG Ex. 3.03.

would collect \$10,760,000 more in customer charges than justified by its customer costs. AG Ex. 3.0 at 10. The Commission should reject IAWC's excessive customer charge increase.

Staff recommends a \$14.75 customer charge in its rebuttal testimony for Zone 1 and Chicago Metro, a lower rate for Lincoln and a higher rate for Pekin. Staff Ex. 12.0 at 8 & Sch. 12.1 at pages 17, 30, 41, 56. Both Staff witness Boggs and AG witness Rubin explained that IAWC witness Herbert's rate design would over-collect customer costs by using multiple customer class ratios. Staff Ex. 4.0 at 27; AG Ex. 3.0 at 10-12. A consistent use of the AWWA meter ratios to set the customer charge rate design is consistent with past Commission practice and will assure that customer charge revenues closely match customer costs.

The People request that the Commission reject the Company's customer charge because it is not cost based, resulting in an over-collection of customer costs and an under-collection of other charges, in violation of cost of service principles. The Commission should adopt the customer charge levels recommended by AG witness Rubin, and use the AWWA meter ratios to develop total customer charges.

VII. CONCLUSION

For the foregoing reasons, the People of the State of Illinois request that the Commission make the adjustments and disallowances discussed above, adopt an allowance to capture consolidated tax savings for Illinois consumers, reject Rider RAC, and make the rate design changes recommended above.

Respectfully submitted,

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